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Roger Pearson
General Editor
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The Divergence of Longstanding Allies

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The ending of the Cold War has generated a far less predictable, and more unstable world. These changes are likely to put significant strains onto international alliances that had been established in the early 1950s specifically to cope with the bipolar situation that was then developing. This article examines the possible ramifications on NATO of the probable acquisition of a missile defense by the United States, an issue that may have greater long-term impact than even the recent events in Kosovo.

Key Words: NATO, post-Soviet international scene, Strategic Defense Initiative, Tactical Missile Defense.

Brief Historical Review

It has taken the unfortunate events in Kosovo to illustrate that NATO, and indeed U.S security agreements in general, will be subjected to ever-greater strains as the full ramifications of the evolving world geopolitical situation are better understood. A major celebration had been planned for the Washington meeting in April 1999 in honor of NATO's 50th birthday. It had been viewed as an opportunity to toast the success of NATO's effective victory over the Warsaw Pact nations without having to fire a single shot, and as a unique opportunity to plan for future broadening of activities. In practice, the anniversary was overshadowed to such an extent by the events in Kosovo that the celebrations had to be muted, and some pundits even reopened the question of whether the organization really has a role in the future.[1,2] Questions have been asked about NATO's mission since the fall of the Soviet Union, and these inevitably became more pointed as NATO pursued the Kosovo activities outside of the UN Security Council. While Kosovo might in the long term prove to be a pivotal point in the future of NATO, it is clear with hindsight that cracks in the Western alliance have been developing for some time, even before the final collapse of the bi-polar domination that determined world security attitudes for close to four decades. America, presently the sole superpower, appears to foresee much broader global

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responsibilities than previously, and these will not always be fully in accord with its European partners.

Ironically the disruption of the close cohesion of the Western allies may well have been started by the then totally unexpected announcement of the establishment of the Strategic Defense Initiative (SDI), which was conceived by President Reagan as a means of breaking out from the shadow of nuclear holocaust, under which the world had lived for over 25 years.[3] The central theme of the President's speech is encapsulated in the following extract:

> What if free people could live secure in the knowledge that their security did not rest upon the threat of instant U.S. retaliation to deter a Soviet attack, that we could intercept and destroy strategic missiles before they reached our own soil or that of our allies?

The key words were interpreted abroad as implying that the U.S. had the ability to change from a deterrent posture to one of secure defense. This immediately raised the question of how secure that defense would be for allies that had been sheltered for decades under the U.S. umbrella of extended nuclear deterrence. In the absence of unequivocal assurance that their security was safeguarded, the concept did not prove any more appealing to friends than to foes. Instead of the enthusiastic support which the President expected, he was bombarded by criticism from all sides. The Democrats in Congress were strongly opposed to a major new defense program, particularly one which appeared to jeopardize continued adherence to the ABM Treaty. The Soviets were concerned that the strategic change would allow America to consider a first strike option, on the basis that an effective defense would enable America to cope with the limited retaliation the Soviets could muster after a surprise attack. Allies were equally concerned that the threat of instant nuclear retaliation on behalf of an attacked ally, by a well-defended America, might not carry the same conviction to a potential aggressor, since America itself would no longer be vulnerable. The concern was that a truly effective defense against nuclear missile attack could lead to a retreat from international commitments to a "Fortress America" policy.

At the time of the President's announcement there were no prepared answers for profound questions such as these; how such a major change

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would affect policies that had dominated international security for so long? In short, would the deployment of a defense aid or detract from stability? These national and international problems arose because the fundamental issues associated with such a major policy change had not been thought through prior to the President's announcement. It is a lesson that does not appear to have been sufficiently well learned, as subsequent policy changes associated with missile defense issues continue to be made prematurely.

By the time it was recognized that what was being proposed was a research program to investigate the possibility of developing a non-nuclear missile defense, the opposition to the concept had reached major proportions. The proposal had brought together such diverse groups as unilateral and multilateral nuclear disarmers, pacifists, concerned scientists, allied Governments and the Soviets into a united opposition against SDI.[4] That opposition, while now more muted, has never fully faded. It is to some degree resurrected each time the question of modifying or withdrawing from the ABM Treaty is raised in connection with the U.S. desire to deploy a National Missile Defense (NMD).

In 1983, when President Reagan made his epoch-making SDI speech, he was attempting to seek alternative solutions to the Mutual Assured Destruction, MAD, policy that had so dominated East/West relations. He even made it clear that he was seeking a non-nuclear defense, in total contradiction to the deployed defense, then and today, around Moscow, which would utilize nuclear warheads on the interceptor missiles. As the research program which he initiated progressed, it became clear that the solution to defending against the massive attacks that the Soviets were capable of launching was well beyond the engineering and technological capabilities that were available, or even likely to mature in the next decade or two.

These conclusions emerged as the Soviet Union itself began to collapse, removing the immediate danger of an East/West confrontation. However, this East/West confrontation was quickly replaced with a rapid growth of inter-ethnic disputes accompanied by an equally rapid growth in proliferation of missile and unconventional warhead technology. The threat has now changed from the potential of a massive sophisticated attack from a single source, to that of smaller-volume raids of reduced sophistication, but from a number of different, and far less predictable, opponents. These changes have made President Reagan's initial postulate

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more, not less, relevant, as several nations acquire the capability of projecting power well beyond their own borders. The research of the past 16 years has pointed the way to the achievement of an effective defense with growth potential to meet even more sophisticated threats that might emerge in the future.

During the early and mid 1990s, these newly missile-capable nations would not have been able to threaten mainland America – only U.S interests and the homelands of some allies, as illustrated during the Gulf War, when Iraq launched Scuds against Israel and allied troops in Saudi Arabia. These attacks resulted in a change in program emphasis giving priority to Tactical Missile Defense (TMD) designed to counter shorter range missiles which might be used against U.S. troops or interests. It was noted at the time of the program change that despite vigorous attempts by the Reagan and Bush Administrations to encourage allies to support the concept of missile defense, only Israel was prepared to commit significant resources.[5] It was suggested at the time that SDI carried far too much baggage to be fully accepted in America, let alone by the allies. Even the change to TMD had been accompanied by the introduction of a space based concept called Global Protection Against Limited Strikes (GPALS) which seemed to many to perpetuate the SDI concept in another guise. In retrospect it is clear that although America kept the allies well informed of their missile defense activities, and would have welcomed cooperation, no coherent policy was ever developed to achieve this objective. The allies throughout remained unsure of U.S. intentions, and with the exception of Israel refused to acknowledge the growing missile threat. The result has been an expanding capability gap between America and its traditional allies, which will undoubtedly cause further difficulties in the future.

By 1994 under the Clinton Administration the focus of missile defense had become clearly TMD, and this was reinforced by a name change of the lead organization to BMDO, Ballistic Missile Defense Organization. At the same time the Administration turned its attention from the allies towards Russia, in an effort to overcome perceived ABM Treaty restrictions on TMD capabilities, and of course the undoubted limitations on an NMD, which was then being pursued as a technology program.[6] This change of policy missed the opportunity of approaching global defense through the route of TMD. Confidence could have been built up by all participants in a joint, non-threatening defense effort,

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including Russian participation. Indeed Russian officials had suggested that the restrictions of the ABM Treaty applied only to national and not to supranational defense systems.[6] This route was not followed, and U.S./Russian talks on the ABM Treaty and missile defense have continued sporadically without as yet reaching any conclusion which would enable the U.S. to deploy an effective NMD.[7] The talks have led to agreements which appear to extend some of the restrictions of the ABM Treaty into the TMD area, but these have never been presented to the Senate for approval. They are therefore still of an uncertain legal status, although the Administration continues to limit the capabilities of systems under development in accordance with these unapproved agreements.

The Present Position

The U.S. Administration appeared to have changed its position on NMD on 20 January 1999, when Secretary of Defense Cohen acknowledged the existence of a ballistic missile threat and announced an increase of $6.6 billion for work on NMD over the next five years. Cohen indicated that research would be directed toward making a decision in the year 2000 on the capability of fielding a defence which could be deployed by 2005. He also stated that discussions would continue with Russia with the objective of modifying the ABM Treaty to enable an effective defense to be deployed, but that the present development would be consistent with the restrictions of the Treaty. It is still unclear whether this announcement by Cohen was a political move to act ahead of Congress, which appeared set on passing a new Missile Defense Act (which was approved by both houses in late May, but has not yet received Presidential signature, see below), or represented a clear difference of opinion within the Administration. Only a day or two following Cohen's announcement, it was revealed that President Clinton had advised President Yeltsin ahead of time of the Secretary of Defense's statement, and also assured the Russian President that no decision on the deployment of NMD had been taken. Subsequently members of the National Security Council have indicated that they do not favor significant modifications to the ABM Treaty, which they still consider to be a cornerstone of US security policy. Furthermore within a week of allocating the further funding to NMD, Cohen was indicating that up to $240 million might have to be reallocated to pay for the Palestinian/Israeli Wye agreements.

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The Missile Defense Bill has taken a very unusual path through Congress. Instead of the usual conference to resolve differences in wording, the Senate added two amendments to the House NMD bill, which was reaccepted as amended by the House. Although the bill calls for the deployment of an NMD system, the White House has made it clear it continues to oppose deployment, and because the bill does not appropriate funds for a specific architecture, will not be bound by its requirements. The director of defense policy and arms control on the National Security Council has stated that in addition to technology readiness three other criteria will be taken into consideration before a deployment decision will be made. These are the nature and scope of the threat, the cost of the system and the impact on arms control.[8] In short, the Administration has indicated that even signing the bill into law will not change Administration policy.

Until very recently Administration spokespersons had vehemently denied any short term missile risk to the U.S. They referred confidently to intelligence assessments that it would be 15 years or more before any nation other than Russia or China could threaten the U.S. mainland with missiles. These statements were usually accompanied by the assurance that these two nations no longer target their missile at U.S. cities, without admitting that retargetting to pre-identified locations takes merely a matter of minutes. The effects of the reported Chinese theft of American nuclear weapon design information has been similarly downplayed, even as China continues to campaign against the deployment of an NMD, and any cooperation on a TMD with Asian allies.[9]

The Clinton Administration continues to insist that diplomacy and international treaties provide the real security against missile attacks. They claim their policy of supporting research in preparation to deploy a defense, if and when it is needed, is prudent and adequate, even if falling well short of the Cohen statement of January, and the Congressional Acts of April, which still had not been forwarded for Presidential signature by late June. The President had indicated that he would veto the Missile Defense bill, but the large supporting majorities in both Houses appear to make the bill veto-proof, so it is likely to become law, even if not chosen Administration policy. The subsequent statements by White House officials seem designed to obfuscate the issue, and indicate that the Clinton Administration will continue to make every effort to avoid agreeing to deploy an NMD.[8] This saga has continued with

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the report that in private discussions associated with the june 1999 G8 meeting in Cologne, President Yeltsin agreed to allow officials to hold discussions to modify the ABM Treaty which would enable America to deploy an NMD. A report which one commentator heavily criticized as "building a bridge to nowhere."[10]

It seems to be a safe assumption that in addition to confusing the American public by these conflicting reports, the Clinton Administration will have left allies highly uncertain of the real U.S. intentions with respect to NMD. It is an uncertainty that can only add significantly to anxiety in European capitals as the ramifications of the possible deployment of an American NMD become clear. It will not take much analysis to reveal that an NMD providing America with security against missile attack will make it a significantly less attractive target for those overt or potentially hostile nations that have invested heavily in offensive weaponry. An obvious alternative for those wishing to strike at U.S interests, or prestige, will be to target those U.S. allies, which apart from Israel have shown no willingness to protect themselves. Such a realization is likely to reawaken the strong international opposition to missile defense that was such a feature of the early days of the SDI program. Allies that have relied for decades upon America to provide the ultimate deterrent will not wish to see conditions change in a manner that could diminish the certainty with which that deterrent might be used. The irony of the situation is that there was probably far less likelihood of a missile exchange during the Cold War than in the present situation, in which proliferation has led to several nations acquiring the capability to project power well beyond their own borders. There is also the possibility that some of these potentially hostile countries, such as North Korea, Iran and Iraq, which have been accused in the past of supporting terrorism, might be willing to supply missile systems to terrorist organizations. Such sub-national groupings are far less likely to be restrained by the threat of retaliation than sovereign nations. If deterrence cannot prevent an attack, the only hope of survival will lie in an effective defense, and those without one will become a more tempting target for ballistic or cruise missile attacks.

There is therefore ample supporting logic for the U.S., as the only remaining superpower, to invest in an NMD, even though by so doing they may well make their allies more susceptible to threats of attack, unless they also quickly follow down the path of acquiring a defense.

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The evidence to date indicates that limitations on defense spending have created strong opposition in allied political and military circles to investment in missile defense. This is partly because the cost would be prohibitively high for an individual country, and partly because the funding would have to come at the expense of other military projects. While Ballistic Missile Defense remains an interservice project, it is certain that it will receive less military support than the preservation of the individual core programs of each Service. In many military eyes it cannot be allowed to take precedence over planes for the Air Force, ships for the Navy, or tanks and guns for the Army. This problem has been exacerbated by recent events such as the ventures in Bosnia, Iraq and Kosovo, making major demands on already overextended defense budgets. At the time of writing, the Congress and the Administration have agreed on a large supplemental appropriation to fill the unbudgeted funding drain on the U.S. Department of Defense. The pendulum has swung wide, aided by the inclusion of many non-military items (referred to as "pork"), but based on historical precedents, this situation is unlikely to last. There is no evidence yet that other NATO members are following the U.S. lead, so the prospects for new programs in Europe are even less likely than before.

Another factor that will add strain to the alliance is the growing tendency of U.S. Administrations to avoid American casualties when committing U.S. troops to crisis areas overseas. The activities in Kosovo suggest that under the leadership of President Clinton this policy may have even superseded the original objective of the deployment, and that the principal driving force in deciding the rules of engagement has become the minimization of the risk of loss of American lives. It will not take long for this lesson to be learnt by potentially hostile nations, and could make it much more difficult in the future to aggregate multinational forces. The message clearly being sent to potential aggressors is that the acquisition of offensive ballistic missiles will make it much less likely that American troops will be deployed within range of such systems, until America can deploy an effective TMD. Allies will be even more wary of getting involved in a crisis that could result in missiles being targeted at their own home territory. For example, if Serbia possessed the capability of targeting Rome, Paris or London with ballistic missiles, would the Italian, French and British be participating in the air offensive? Would American planes be operating from bases so close to the Serbian border?

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A recent article in the *Washington Post*[11] suggested that for a number of reasons the concept of the U.S. being the sole superpower is flattering rhetoric that leads to careless analysis and extravagant expectations. Kosovo was cited as one example of massive miscalculation, leading to the danger that as the public grasps the ambiguities of the post-Cold War era there will be pressure for disengagement. This interpretation appears to have made little impression on the President who has indicated that the intervention into Kosovo provides a precedent to halt "ethnic cleansing" worldwide, and which is already being referred to as "the Clinton Doctrine."[12] This is a doctrine that is totally at variance with the fears that so concerned NATO allies in 1983, but in this much-changed political environment is likely to cause no less concern. This, together with the other strains already present within NATO could, if not forestalled, lead to a much reduced effectiveness of NATO and other alliances, if indeed it is agreed that NATO has a real role to play in the future.

The dangers of America taking on such a broad police-keeping role are highlighted here so that the importance of the strains it is likely to induce within traditional alliances are clearly recognized. Failure to take these properly into account could threaten the very existence of such alliances and lead to their premature break-up. Such a forecast would not appear to be in the interest of America or any of its traditional allies in Europe, Asia or the Middle East. Ballistic missile issues can no longer be avoided and should feature significantly in future international policy discussions. The effects of the failure to do so, are all too clear.

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Financial Globalization and National Macroeconomic Policies: Managerial Challenges to the Nation-State

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Examination of the interplay between global financial markets and national currency, budget and monetary policies, using recent examples, including Mexico's 1994 crisis, the British ERM episode, and the recent Asian contagion. This study finds that when 'policy misalignments' exists, that is when governments adopt monetary policies that has the unintended effect of undermining the soundness of the economy and the financial system, markets act as a disciplinary mechanism, sanctioning policy mistakes.

Key Words: Globalization, national economic policy, financial crises, exchange control, devaluation.

I. Introduction

Globalization is commonly understood to mean a deepening "internationalization" and interdependence among nations in the form of cross-border exchanges of goods, investments, people, money, messages and ideas. Another usage associates "globalization" with the liberalization of borders, as many countries reduce regulatory barriers to international trade, travel, financial transfers and communications. While the vocabulary of international relations can easily describe the trends in cross-border relations or "internationalization," the concept of "liberalization" is sufficiently precise to explain the opening of borders. Yet these two conventional constructs tell us nothing new. Indeed, critics may be rightly asking why such a fuss is made about these issues.

Therefore, this article is informed by a more innovative construct. "Globalization" may be regarded as those transborder relations which extend across widely dispersed locations, transcending territorial borders. In a similar vein, we define financial globalization as the emergence of a single, increasingly integrated and universal world financial markets operating 'transnationally', and therefore largely transcending state

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frontiers.[2]

The globalization of money and finance is perhaps the most significant expression of the transcendence of national territorial space. As a result of rapid increases in telecommunication and computer-based information technologies and products, and the new instruments and risk management techniques they have made possible, a dramatic expansion in global financial flows within and across countries has emerged. As a consequence, an ever wider range of international firms are able to manage their financial and currency risk exposure more effectively, thus enabling them to concentrate on managing the economic risks associated with their primary business. Dramatic gains in communications and information technologies have enabled financial markets to develop and use complex financial instruments such as put and call options, interest rate swaps, 'short positions', etc.

New technologies have made it possible to deploy complex financial instruments and techniques, and in the process have strengthened interdependence among markets and market participants, both within and across national boundaries. The recent financial turmoil in Hong Kong, South Korea, Taiwan, Thailand, Singapore, Malaysia and Indonesia, and the turmoil in the European exchange rate mechanism in 1992, confirm that in a world of global financial mobility, a disturbance in one market segment or one country is likely to be transmitted to other segments of the market and to reverberate with astonishing rapidity throughout the world economy. This contagion effect was almost unthinkable two decades ago.

Many of these global transnational financial flows are based on worldwide portfolio investing. However, in terms of global economic fundamentals, such flows of capital are part of the transworld economic architecture that supports the efficient international movements of goods and services. The solid profitability of these and other financial products lends support to the general proposition that the increasing effectiveness

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[2] This section draws heavily on the work of Jan Aart Scholte, "Global Capitalism and the State," *International Affairs*, Vol. 73, No. 3 (July 1997), pp.- 430-437. international' For other meanings of globalization and financial globalization see, Stephen Gill "Globalization, Market Civilisation, and Disciplinary Neoliberslism" *Millennium: Journal of International Studies*. Vol. 24, No. 3 (1995) 399-423; and Eric Hobsbawm, *The Age of Extremism* (Toronto: Penguin Books, 1994), 287-343.

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of financial markets helps facilitate the flow of trading and direct investment, and in the process, contributes to raising the overall standard of living around the globe.

In the high technology financial markets of the 1990s the link between money and territory has loosened due to the borderless cyberspace of banking computers, the free electronic cross flows of national currency, the globalization of medium and short-term maturities (e.g., medium-term notes, commercial paper, repurchase agreements, and the rapidly growing listings of securities on various foreign stock exchanges, as for instance, American Depository Receipts on the New York Stock Exchange) and the advent of debt and equity securities trading through computer network-based dealers, instead of the floor of financial stock exchanges.

The globalization of the world economy is undeniable. Recent economic turmoil in Asia proves this. Real estate lending in Thailand precipitated a stock market crash in Hong Kong, where 75 percent of the market capitalization is real estate-based, which sent the Dow Jones industrial average into a tailspin. However, the effect of globalization on 'economic sovereignty' and the modern nation-state has been the subject of heated debate cutting across various disciplines. In the liberal tradition of international political economy, some observers have argued that globalization has robbed governments of even a minimal degree of influence with regard to the management of macroeconomic policy. They claim that global integration is emasculating the modern state. The tasks that have traditionally been regarded as the realm of public governance have moved beyond the reach of government, and thus beyond the reach of voters. Global markets are in charge. Governments often have little else to do other than to stabilize prices and government spending in order to avoid pressures on their currency and to attract direct foreign investment. According to adherents of this view, globalization of the international economy fueled by the liberalization of capital movements, the deregulation of major financial markets and the adoption of floating exchange rates, has undermined the ability of the modern nation-state as an effective unitary economic actor.[3] As Evans has observed,

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[3] Some of the notable recent works that explore this theme are Vivien A. Schmidt, "The New World Order, Incorporated: The Rise of Business and the Decline of the Nation- State" in *What Future For The State, Daedalus: Journal of the American Academy of Arts and Sciences*, Vol. 124,

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No one questions that the traditional Waltzian logic that competing 'national interests' continue to drive the 'interstate system,' but the muted great power struggles of the post-bipolar world leave international relations increasingly contaminated and often vershadowed by the private logic of the global economy.[4]

Global economic integration thus explains, at least in part, the political malaise affecting many of the world's major democracies. These developments have largely enfeebled the modern territorial nation-state.

Support for the view that global integration has enfeebled the state is widespread. It comes from socialists and conservatives alike, in large countries, and in small countries which have suffered the loss of economic sovereignty even prior to the advent of contemporary globalization, as documented by the dependency theorists. According to the 7 October 1997 issue of *The Economist,* a former British Chancellor of the Exchequer put it best, 'the plain fact is that the nation state as it has existed for nearly two centuries is being undermined...The ability of national governments to decide their exchange rate, interest rate, trade flows, investment and output has been savagely crippled by market forces.' In that same issue, another notable authority has observed that 'The state's powers over the price of money...tax rates, industrial policy, the rate of unemployment, have been blown away.'[5]

In support of this perspective it can be said that the scale of economic activity no longer corresponds to the territory of the nation-state. In this global environment governments that adopt protectionist trade policies, advocate restrictions on direct foreign investment and adhere to national monetary policies that try to buck transnational financial markets, will render their economies unattractive to international investors and trade, and consequently become noncompetitive and unsuccessful.

At the other extreme, adherents of the realist tradition of international political economy continue to stress the primacy of the nation-state as the central actor. Krasner, for example, sees national governments as the real actors in the formation and implementation of

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international economic policy.[6] Similarly, Robert Gilpin has argued that since the initial movement of American capital and corporations abroad, the State Department and the White House have sought to channel American foreign investment in a direction that would enhance the foreign policy objectives of the United States. According to Gilpin (1975), it was the concerted efforts of nation-states, the United States in particular, that created the post-World War II economic institutions such as the IMF, the World Bank, the GATT. These institutions in turn created the foundation for a global economy based on open and expanding international trade, monetary relations, and foreign investment.[7]

The realists have correctly argued that underlying contemporary international economic relations is the reality of the persistence of nation-states and interstate relations as the bedrock of international economic governance. As public institutions continue to formulate responses to exchange rate and financial instability, they mediate the impact and shape the consequences of globalization. As some adherents of the realist and the 'neomercantilist' schools have argued, evidence suggests close interdependence between the effectiveness of economic governance by nation-states and collective governance through multilateral institutions.[8] However, realist writers fail to appreciate that global transnational economic relations have created a new context for state actions in national and international economic policies. Increasingly, private transnational cross-border transactions have been the source of wealth and power, creating doubt that states are the preeminent actors they once were.

This article takes the position that the interplay between the transnational economic forces and the territorially bound nation-state lies somewhere between the extremes of globalism that sees a state's

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[6] Robert Gilpin, *The Political Economy of Direct Foreign Investment* (1975). Further, Geoffrey Garrett has pointed out, in some instances globalization, instead of diminishing the authority of the nation-state, has led to the expansion of government authority and government spending. See Geoffrey Garrett, "Capital Mobility, Trade and the Domestic Politics of Economic Policy," *International Organization*, Vol. 14, No. 4 (1995), p. 683.

[7] For an elaborate treatment of this theme, see Shah M. Tarzi, "Multinational Corporations and American Foreign Policy: Radical, Sovereignty-at-Bay and State-Centric Approaches," *International Studies*, Vol. 28, No. 4 (1991), pp. 360-371.

[8] Examples include, WTO, World Bank, IMF, and regional bodies such as EU and NAFTA, OECD, the Bank for International Settlements (BIS), UN agencies, and the Group of Seven (G7). See, for instance Jan Aaart Scholte, "Global Capitalism and the State," *International Affairs*, Vol.73, No. 3 (July 1997), p. 450.

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international economic function as essentially obsolete and the realism of Krasner et al. Global integration has dramatically changed the rules of macroeconomic policy. Specifically, I argue that in circumstances where 'policy misalignments' exist, defined as a basic incompatibility between economic fundamentals and macroeconomic policy fundamentals, markets act as a disciplinary mechanism, punishing national governments for unsustainable economic policies out of synch with the reality of economic fundamentals. These policy misalignments may be imbedded in an overvalued exchange rate, bulging current account deficits, excess economic capacity, expansionary monetary policies, etc. that tend to undermine the soundness of an economy and its financial systems. National policies that are out of synch with deteriorating underlying economic fundamentals, in turn, create disturbances in markets, as market participants, both domestic and international, lose confidence.

Using the financial markets as a point of departure, I will argue that the plunge in the exchange value of the Mexican *peso* at the end of 1994 and early 1995, the turmoil in the European Exchange Rate mechanism in 1992 and the recent sharp exchange rate adjustments in a number of Asian economies, are examples of how global finance acts as a punishing level on policy misalignments, actual or perceived" with shocking alacrity. One striking feature of the market's disciplinary action, one that is entirely a new development in the global economy, is that it has changed the timing and the severity of the consequences, if economic constraints and fundamentals are ignored. The effect of globalization, it will be shown, is not so much that governments are forced to sacrifice "national economic sovereignty," rather it is that is in a world of increasing capital mobility there is a premium on adopting and implementing a sound budget and interest rate policy, creating a robust financial system, and allowing exchange rates to provide appropriate signals for the broader pricing structure of the economy. Markets will react sharply to significant mistakes in these areas of macroeconomic policies.

In short, this study will illuminate the thesis that global markets act as a "disciplinarian" of national governments in circumstances where governments engage in policies incompatible with economic fundamentals. This article will show that a basic incompatibility between the expansionary monetary and fiscal policies of the several governments and the fixed exchange rate regime, an incompatibility that could not be

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sustained with a finite stock of international reserves, has been central to understanding financial problems in Mexico and Hong Kong. For example, the static response of the national governments in Mexico during the *peso* crisis and most recently, the failure of Hong Kong's financial authorities to stave off global financial pressure, including speculative attacks, both spring from an incompatibility between government policy and a fixed exchange rate. In these instances, a combination of rising nominal interest rates, rising wages and prices, overvaluation of the real exchange rate, and in the case of Mexico, a widening of current account deficits, made it difficult for these governments to sustain their commitment to peg the nominal exchange rate. Therefore, the issue is not, as adherents of globalization would argue, the loss of economic sovereignty. Rather it is the adoption of inappropriate and unsustainable economic policies. Likewise, as various examples below will show, the view of those who argue that national governments are the dominant unitary economic actors is not adequate. Domestic and international financial forces do severely limit the ability of national governments to engage in and maintain unsound macroeconomic policies. This is especially the case when the country in question is a recipient of large sums of highly liquid portfolio investments.

One major implication of the analysis of those who argue that globalization has caused a serious loss of 'economic sovereignty' is that somehow this is a highly negative or disruptive development. In contrast, the central implications of this study will be that market response, while sometimes disruptive and negative, overall, is a highly positive self-correcting mechanism. Put differently, the maintenance of financial stability in an environment of global capital markets calls for greater attention by governments to the soundness of public policy.

In the literature four major cluster can be identified regarding the globalization of financial markets and the interplay between the state and global finance: (1) many accounts seek to explain it with reference to technological and market forces (2) several studies emphasize the behavior and interests of states as important determinant of the globalization of financial markets (3) literature dealing with the loss of national economic sovereignty due to globalization; and (4) the financial

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and economic causes of capital flows and currency crises.[9] In contrast to the existing body of work, this study fills a gap in the literature by paying greater attention to the ways in which "public policy misalignments" or incompatible and unsustainable government policies trigger reactions in the global markets, and how global market forces and national economic fundamentals interact. As a result, this study takes preliminary steps towards identify and explaining various types of constraints on the economic policies of national governments.

II. Fixed Exchange Rates Policy and Financial Globalization

In the mid-1970s, the major industrialized countries abandoned the Bretton Wood fixed exchange rate system agreed upon thirty years earlier in favor of the free market system of floating exchange rates. The free market system offered a mechanism for correcting trade imbalances and stabilizing economic activity. This system allowed exchange rates to better reflect macroeconomic fundamentals such as incomes, money supplies, and interest rates. Fixed exchange rates, by contrast, tended to be economically and politically not feasible, as demonstrated by the collapse of the Bretton Woods agreement. Specifically, the fixed rate system leads to unpredictable exchange rates in part because rates are arbitrarily set by governments. Rates thus become subject to the vagaries of political and bureaucratic developments and do not accurately reflect economic fundamentals. Fixed rates thus make it possible for fiscally irresponsible governments to export their inflationary policies abroad.

The mismatch between the macroeconomic policy of fixed rates and the underlying fundamentals of a country's economy creates opportunities for financial speculation, as investors correctly anticipate adjustments in otherwise unsustainable fixed rate pegs.

Since exchange rates are the relative prices of currencies and since the relative price of currencies, like any other goods, can not be fixed in

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[9] One major representative work of the first genre is, Adrian Hamilton, *The Financial ¡Revolution* (New York: Free Press, 1996); For works that emphasizes the role of the state see, Eric Helleiner, "Explaining the Globalizatin of Financial Markets: Bringing States Back In", *Review of International Political Economy*, Vol. 2, No.2 (Spring, 1996), pp. 315-41. For works on the loss of sovereignty see, Stephen Gill, "Globalization: Market Civilization and Disciplinary Neoliberalism", *Millennium: Journal of International Studies*, Vol. 24, No. 3 (1995), pp. 399-423; For the fourth genre of literature see, Jeffrey D. Sachs , Aaron Tornell, and Andres Velasco, "Financial Crises in Emerging Markets: The Lessons from 1995" *Washington: Brooking Papers on Economic Activity*, Volume 1, 1996.

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the long run, a fixed exchange rate system is, in the long run, not a viable option. Yet many governments, for reasons beyond the scope of this article, have opted for fixed rates.[10] In such a circumstance, global financial markets have acted to discipline national governments for policy misalignments. Consequently, governments have been forced to alter economically unsustainable policies or preserve a policy posture at a huge price.

One aspect of the fixed rate regime especially warrants attention: Whenever there is a discrepancy or policy misalignment between the monetary and fiscal fundamentals required to preserve the exchange rate peg and the actual behavior of these macoreconomic fundamentals, a balance of payments crisis is likely to occur. This imbalance will in turn give rise to a currency crisis and speculative financial attacks of a global nature. In a country host to large global portfolio investments, such events are followed by severe international financial market reactions in the form of quick withdrawal of portfolio investments. Governments are often unable to stave off both the initial reactions of global financial market participants and the consequences of market actions.

As we shall see later, such was the case regarding the 1994 Mexican currency crisis. Here the Mexican government pursued expansionary monetary and fiscal policies inconsistent with the peg. The latest currency crisis in Hong Kong, South Korea, and the British experience with the Exchange Rate Mechanism (ERM) in 1992 also demonstrate the vulnerability of national governments to the challenge of global financial markets in circumstances where governments pursue incompatible and unsustainable macroeconomic policies.[11] The sheer size of the financial flows through such derivative instruments could, in turn, precipitate an exchange rate adjustment crisis. Below we will comment on these crises to illuminate the broader thesis set forth in the introduction.

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[10] The discussion on the role of fixed versus floating exchange rate is informed by the work of Arthur J. Rolnick, Director of Research, and Warren E. Weber, the Federal Reserve Bank of Minneapolis. See their insightful work, "A Case for Fixing Exchange Rates," *1989 Annual Report*, a publication of the Federal Reserve Bank of Minneapolis. This report may be accessed at: http://woodrow.mpls. frb.fed.us/pubs/ar/ar1989.html.

[11] Investors might 'short' the exchange rate or buy put options, bidding that the rates will be adjusted downward. Alternately, they might 'go long' or buy 'call options' in anticipation of upward rate adjustments.

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III. Mexico's Current Account Deficits and the Peso Crisis of 1994

Mexico introduced several market driven economic reforms in the 1980s, including trade and investment liberalization, privatization, deregulation, tightening fiscal policy, and entry into the NAFTA regime. The Mexican economy responded. The country recorded growth of 3.9 percent in both 1990 and 1991, and inflation fell below 20 percent in 1992. Further, exports grew swiftly, wage levels stabilized and the debt crisis seemed to have been brought under control. One major remaining economic problem was a huge current account deficit financed in part by global portfolio investments. Wall Street in particular was searching for high returns in Latin American stock markets or buying dollar-denominated Mexican *tesobonos.* These were debt issues which enabled the Mexican government to exchange large quantities of *pesos* for dollars, building up substantial reserves which the government planned to use to support the high exchange rate peg. Capital inflows which began in the late 1980s accelerated swiftly in the early 1990s, and reached a record high of $29.4 billion in 1993. The changing pattern of the capital markets in Mexico was increasingly obvious as the Mexican equity prices (in dollars) were ten times higher at the start of 1994 than their level at the start of 1989. Yet, in spite of these successes, the 1994 crisis unfolded quickly and forced the Mexican government to change what in retrospect turned out to be a set of unsustainable policies.

The Mexican crisis appears to be a classic case of downward pressure exerted by global financial markets on a pegged (or targeted) exchange rate in circumstances where national authorities pursue macroeconomic policies incompatible with the exchange rate. The Mexican government allowed its current account deficit to rise to about 8 percent of GDP, and financed this deficit by highly volatile, short-term portfolio-based capital inflows. Consequently, this equilibrium became vulnerable to domestic or international shocks that could, in turn, change the sentiments of foreign portfolio investors, Wall Street institutional investors, and particularly bond and equity fund managers. The economy was vulnerable because capital inflows large enough to finance such a huge current account deficit were unsustainable. Yet the Mexican government had made an implicit commitment to avoid substantial movement in the nominal exchange rate. This created an urgency to maintain the unsustainable capital inflows and consequently increased their relative importance to the country's economic health. In addition to

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this "flow side" of the crisis, the rapidity with which domestic monetary aggregates grew in conjunction with the conversion of *cetes* into dollar-denominated *tesobonos,* referred to earlier, combined with erosion of official foreign exchange reserves, made the public sector generally, and the banking sector in particular, increasingly vulnerable. To these may be added growing doubts about the government's fiscal and monetary discipline, along with inadequate policy responses to burgeoning current account deficits. These factors precipitated a self-fulfilling attack on the *peso* and helped trigger the September 1995 confidence shock. The ultimate result was a drastic withdrawal of liquid portfolio investments.

It is instructive to note that the Mexican government was forced to widen the exchange rate band on 20 December and to abandon the exchange rate peg altogether in favor of a floating rate on 23 December 1994. As a result, financial markets quickly adjusted the *peso* value, depreciating the *peso* against the dollar by 50 percent in less than two weeks. Abandoning the exchange rate peg meant that the Mexican government was unable to sustain the exchange rate policy, a commitment that created the condition for the initial capital inflows. This led to a crisis of confidence on the part of global financial market participants and to capital outflows. It was only after the Clinton administration's $50 billion rescue package enabled Mexico to pare off the current account deficit that the currency crisis stabilized.[12]

IV Hong Kong

In October, 1997, currency speculators worldwide attacked the Hong Kong dollar, the last Asian currency still pegged to the U.S. dollar. The Hong Kong government found itself between a rock and a hard place. It had the option to ignore this event and see its currency, pegged at $7.80 Hong Kong dollars to one U.S. dollar, depreciate in value. This depreciation would have meant that Hong Kong forsook its top financial

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[12] This account of the Mexican peso crisis is informed by the perceptive work of Leonardo Leiderman and Alfredo E. Thorne, "The 1994 Mexican Crisis and its Aftermath: What Are the Main Lessons?", pp. 1-8, and Andrew Crockett, "Lessons from the Mexican Crisis," pp. 297—299., in Guillermon A. Calvo, et.
al., Private Capital Flows to Emerging Markets After the Mexican Crisis (Washington D.C.: Institute for International Economics, 1996).

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priority which the government considers the key to the island's future economic health. Alternately, it could defend its dollar against foreign currency but at a very high cost to the economy. The government chose the latter option. The financial board of Hong Kong nearly depleted its $88 billion foreign exchange reserves to ward off a run on the currency and protect the exchange rate. In the process, overnight interest rates in Hong Kong reached as high as 280 percent, and left the stock market's Hang Seng Index with its biggest-ever point loss. In percentage terms, the index plunged 10.4 percent. Since about 70 percent of the market capitalization of the Hang Seng is real estate based, the rising interest rate is likely to put additional downward pressure on Hong Kong's financial market. For this and other reasons, the contagion effect of the global financial markets quickly materialized as the crisis spilled over to markets in other Asian countries, Latin America, Europe and North America. The Dow Jones industrial average lost 2.3 percent, Japan's Nikkei 3 percent, London's FTSE 3 percent and Germany's DAX index 4.75 percent.

Rising interest rates are expected to curtail Hong Kong's economic growth. The currency crisis in Hong Kong, Thailand, Malaysia, Indonesia and the Philippines is likely to make a bad economic situation worse in Japan, and according to Wall Street analysts, could shave one quarter to one half percentage point from U.S. economic growth in 1998.

The vulnerability of the Hong Kong currency peg to global financial pressure is embedded in the policy misalignments associated with fixed exchange rate pegs, described earlier. In this case, the exchange rate peg was largely out of synch with excess economic capacity and a slowing economy. Global financial markets correctly anticipated that Hong Kong, Taiwan, Thailand, South Korea, Malaysia and Indonesia would soon feel the pressure to devalue their currencies to make exports more competitive. Further, to correct the incompatibility between a macroeconomic policy, reflected in an overvalued exchange rate peg and the fundamentals of the economy, the markets moved "long" on the American dollar, appreciating its value vis-à-vis these currencies.

The current Asian currency crisis vividly demonstrates the integration of global financial markets and the mismatch between a radically globalized financial system and the economic leverage available to national governments. Indeed, the economic cost to Hong Kong, one of the strongest monetary authorities in the world, far exceeded the benefits of guarding the currency.

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Those who argue that national governments have lost the ability to manage the economy in the face of globalization would regard the recent Hong Kong currency crisis as evidence in support of their arguments. Realist writers, and those who adhere to state-centric approaches, will no doubt point to the ability of Hong Kong's Financial Board to stave off the attack by global currency speculators—the Hong Kong dollar closed at $7.71 down from the $7.80 official peg – as an example of the ability of determined national monetary authorities to fend off powerful forces if economic stakes are high enough.

However, what happened in Hong Kong reveals, contradicting the Realists, that globalization does constrain the ability of national governments to carry out or sustain micro-economic policy. This is not due, however, to the 'loss of economic sovereignty,' rather it is caused by "policy misalignments" or incompatible and unsustainable government policies. To the extent that national governments are forced to adopt policies in accordance with improving economic fundamentals, the ramifications are, contrary to the alarm over the image of a powerless state embedded in the neoliberal position, an aid to better serve national economic interests. Overall, economic fundamentals in conjunction with the forces of global markets act as constraints on the policy of national governments. More importantly, unlike the past, the reaction of markets to serious national macroeconomic policy mistakes tends to be sharp, quick and severe, a phenomenon of financial globalization.

V. Britain and the ERM Episode of 1992

In the British financial markets, September 16, 1992 is known as Black Wednesday. On that day an uncontrollable wave of selling defeated the British government's effort to defend its currency and forced it to leave the European Exchange Rate Mechanism (ERM). This episode is often cited as solid evidence of the powerlessness of national governments in the face of economic and financial globalization. The actual picture is far more complicated when one asks why did waves of "short selling" hit the currency market in the first place and whether the British government's macroeconomic policy was unsustainable and thus vulnerable to such attacks.

In the case of Black Wednesday, the global financial markets correctly anticipated a crisis. This crisis would be caused by inflationary pressures, rising budget deficits and excess domestic credit creation at the

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same time the government sought to preserve a nominal exchange rate peg within a tight ERM regime. Britain had entered the ERM in 1990 at an unsustainable target rate of one pound to 2.95 DM, when the rate of British inflation was almost three times that of Germany.[13] Therefore, it was no surprise that markets responded rapidly to these damagingly overvalued exchange rates.

The financier George Soros, several major Wall Street hedge fund managers and many other currency speculators worldwide correctly concluded that the German DM would continue to muster strength. The German government kept interest rates relatively high in order to sustain capital inflows needed to contribute to the restructuring of the economy of former East Germany. In contrast, Britain's overvalued exchange rate was unsustainable. The British government had deliberately allowed the pound to appreciate against the mark. Consequently, currency speculators went "long" on DM with financial derivatives, including 'call options' and 'sold short' the pound. Short selling in conjunction with the exercise of a huge volume of "put options" accelerated the downward selling pressure. The British government launched a buying spree of the pound on the open market in order to stave off the downward pressure on its currency, but to no avail.

In short, financial and economic fundamentals were incompatible with the ERM required exchange rate. As in the case of Mexico, this incompatibility could not be sustained with the finite stock of British financial reserves. An overvalued exchange rate, undisciplined monetary policy and inflationary spikes conspired to create the preconditions for market reactions. To be sure, prior to the crisis the British government did have the option of devaluation within the ERM, which would have created a more realistic and sustainable exchange rate. However, such action would have raised doubts about British commitment to a unified European currency regime, and therefore was politically not palatable. Once the market concluded that devaluation was unavoidable, reaction was swift, sharp, and powerful. This crisis could have been avoided altogether had Britain entered the ERM at a realistic and sustainable rate. Put differently, effective public policy options to stabilize the exchange rate were available and could have preempted a crisis. It appears, though,

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[13] Paul Hirst, "The Global Economy-Myth and Reality" *Foreign Affairs* , Vol.73, No. 3 (July 97), p. 420.

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that a misguided public policy, not the powerlessness of national governments, was the cause of the crisis.

An important lesson of the Black Wednesday episode is that financial globalization will trigger severe reactions to national government policies that seek to change prices in financial markets. Financial markets punish national policies that are incompatible with or insupportable by real economic fundamentals.

VI. The Southeast Asian Contagion of 1997

The ongoing currency crisis in Asia lends additional proof to the general proposition set forth in this essay that globalization of the financial system has made national governments' exchange rate policies subject to correction in the marketplace. Governments whose national economic policies were misaligned, including the British government, Hong Kong, Mexico, and most recently many South Asian governments, have all blamed marauding currency speculators as the cause of capital crises. There has been such speculation, as the British ERM episode of 1992 shows. However, speculators can not succeed in dislodging an exchange rate system compatible with and firmly aligned to appropriate economic fundamentals, cost structure and policies. A brief exposition of the current Asian crisis will illuminate this argument.

A combination of low levels of inflation and high rates of savings and investment, including investment in human capital through education, led to rapid economic growth in Asia throughout 1970s and 1980s. However, it was in the 1990s that a dramatic rise in foreign net capital inflows took place. The total net inflows of foreign direct investment, equity and long-term debt instrument purchases was $25 billion in 1990, and exploded to over $110 billion by 1996. The portfolio portion, the largest segment, was based on expectations by market participants and investors in the United States, Western Europe and Japan, of a high rate of return in the form of higher yields, rising stock prices and capital gain in these emerging markets, as compared to the developed world. Apparently, the flow of such huge sums of investment money in such a short time was greater than could be profitably deployed with a reasonable risk. In such circumstances of rapid growth and ample liquidity and limited short-term profitable alternatives, the real estate sector absorbed the lion's share of these investments, as shown by lavish construction projects based on marginal economic rationale. A significant

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proportion of the assets of the domestic financial system were thus based on real estate portfolios. As mentioned earlier, the largest percentage of capitalization of Asian stock market exchanges was based on real estate. In Hong Kong, for instance, this was as high as 75 percent. In order to maintain high rates of return on equity, businesses were borrowing heavily, increasing debt leverage which, in turn, added to financial fragility. Direct and implicit government guarantees of debt compounded the problem as lenders slackened vigilance on loans. In these circumstances of sky-high debt and huge real estate portfolios as a basis of financial assets, the margin of error for rising interest rates or economic slowdowns, as recent events in Asia has demonstrated, was razor thin.

Once again, the pegged foreign exchange rate served as the culprit that triggered global financial markets to react. Specifically, the rapidly growing foreign currency denominated debt put pressure on companies to earn foreign exchange to pay interest on corporate debt, thus sapping their economic strength and weakening their export position. Since exports of goods and services figure heavily in the economic growth of these economies, a slow down in export earnings growth and the resulting excess domestic capacity placed many highly leveraged businesses in an economic tailspin.[14]

As a result, the fixed exchange rate regime came under great pressure as institutional investors reduced the pace of new capital inflows. As the fear grew among investors that governments in the region would be forced to devalue their currencies, vast numbers of Asian businesses attempted to convert domestic currencies into foreign currencies and tried to delay the conversion of export earnings into domestic currencies. In response to pressures on the exchange rate,

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[14] This section of the study has benefited and draws upon the insights of several speeches by the Federal Reserve Chairman, Alan Greenspan and other Fed governors. See, Alan Greespan, "Central Banking and Global Finance," remarks at the Catholic University Leuven, Leuven, Belgium, (January 1997); "Globalization of Finance," remarks at the 15th Monetary Conference of the Cato Institute, Washington, D.C. (October 97); and remarks by the Fed chairman before the Economic Club of New York, New York (December 1997). These remarks could be accessed from the Fed's web site at http://www.obg,frb.fed.us /boarddocs/speeches/1997. For an elaborate treatment of this issue see the remarks by the Fed Chairman, Alan Greenspan before the Economic Club of New York, (December 1997) cited in 12 above.

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governments in Asia tried to raise interest rates. This potent combination of higher interest rates and slow economic growth made stock markets vulnerable and the position of domestic financial borrowers untenable.

The currency and economic crisis in Asia highlights several important issues.

(1) Huge current account deficits financed by foreign portfolio investments are vulnerable to sudden withdrawal. Further, large net foreign currency exposures and constraints on exchange rate fluctuations are incompatible with long-term financial stability. Governments that pursue macroeconomic policies encouraging such a state of affairs are likely to trigger global financial market reactions;

(2) The dilemma of monetary policy for national authorities which seek to fix exchange rates is clear: Governments that choose to fix foreign exchange rates are not likely to retain control of interest rates; if they choose to control interest rates, they may not be able to fix the currency. Britain, for example, failed to resolve this dilemma, and the ERM collapsed.

(3) There is a quick contagion effect of weakness or a crisis in one economy spreading to others as investors perceive similar vulnerabilities. The rapid proliferation of financial products and risk management strategies have increased the efficiency of global financial markets, which in turn has made it possible to transmit investment, financial and policy mistakes throughout the system at a pace that would have been inconceivable a generation ago. The 24 November 1994 issue of *Fortune* reports that during the course of the last two months Thailand's currency has lost 58 percent of its value, Malaysia 32 percent, Taiwan 12.1 percent, South Korea 14.3 percent, the Philippines 33.4 percent, Indonesia 53 percent and Singapore 12.3 percent. Declines in the market capitalization of stock exchanges have mirrored currency declines.

To be sure, there are differences in the kind of economic challenges each country in the region faces. In South Korea, for example, the challenge is to restructure the troubled *chaebol* (large conglomerates such as Samsung and Daewoo), open financial markets to foreign investors and recapitalize banks battered by corporate bankruptcies. Further, South Korea needs to rationalize its corporations by freely allowing mergers and acquisition. The Philippines, on the other hand, needs to keep a lid on inflation. Indonesia, Malaysia and Thailand are among the shakiest of the Southeast Asian economies. All three suffer from endemic system-wide

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economic problems: high debt and overcapacity. Indonesia, similarly to South Korean, needs to swallow the IMF's medicine to cut the national budget. The challenge for Thailand is to reduce the trade deficit, put brakes on consumption, move toward more value-added capital-intensive businesses and adopt constitutional reform to stabilize the government. Malaysia has to reduce both public and private debt. All countries in the region, perhaps with the exception of Singapore, need to deregulate their economy and tighten monetary policy so as to squeeze out excesses in the real estate sector in order to cool this overheated segment.

Perhaps the most important lesson of the current crisis is that globalization of finance, by triggering such crises, will accelerate in Asian countries the dismantling of a system that emphasized a disproportionately large role for government-directed investment. Whenever serious mistakes arise from government-directed or influenced investments, private global capital flows will become adverse, exposing misguided policies, and domestic structural and institutional flaws of the system. In the case of South Korea, for example, the government sometimes provided support for ailing companies that should have gone bankrupt, and it extended loans and guarantees to private firms driven, not by market forces, but by a national 'industrial policy.' In many of the Southeast Asian countries facing the current economic and financial crisis, such government loans led to misuse of resources, unprofitable expansions, losses, and eventually loan defaults. When government guarantees those foreign currency-denominated loans, as had been the case in some of the Asian economies, it makes national government vulnerable to the backlash of financial markets.

This account clearly illuminates the proposition that the major issue national governments face in an age of global finance is not 'the loss of economic sovereignty.' Rather it is the misguided macroeconomic policies of national governments that is the culprit. Seen from this vantage point, the globalization of finance is a positive force that exposes macroeconomic policy mistakes.[14]

VII. Theoretical and Policy Implications

According to one school of thought, globalization has enfeebled the modern nation-state and rendered it unable effectively to manage the economy. Global markets are now in charge. At another extreme, adherents of the state-centric interpretation of international political

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economy continue to stress the primacy of the nation-state as unitary economic actor and the dominant force in international economic relations. This article transcends both extremes, by narrowing and recasting the general thrust of the relationship between the state and global economic relations to focus instead on macroeconomic policy. Further, after examining the interplay between global finance and national currency, budget and monetary policies, and using several recent case studies, this study shows that in circumstances where *policy misalignments* exist, when governments adopt monetary policies that have the unintended effect of undermining the soundness of the economy and the financial system, markets act as a disciplinary mechanism, sanctioning policy mistakes. National policies that are not in synch with deteriorating underlying economic fundamentals, in turn, create disturbances in the financial markets, as investors and economic actors, both domestic and international, lose confidence.

Using several case studies, this article has illuminated the ways in which global financial markets act as a punishing level on policy misalignments, actual or perceived, with shocking alacrity. One entirely new and significant attribute of the global market's discipline is that it has changed the timing and the severity of the consequences, if governments ignore the constraints of economic and financial fundamentals. The effect of globalization therefore is not, as critics assert, that it forces governments to sacrifice 'national economic sovereignty,' rather it is that in a world of increasing capital mobility there is a premium on having a sound financial systems, a sound budget and interest rate policy, an exchange rate environment that provides appropriate signals for the broader pricing structure of the economy, and the pursuit of macroeconomic policies that strive to achieve a degree of economic stability. Markets react quickly and negatively to significant macroeconomic policy mistakes by national political authorities. The key issue, therefore, is not that nation-states no longer matter. Nation-states do matter, and national economic policies are still an important determinant of national economic success. The key issue is that global financial integration has had dramatic influence over the rules of macroeconomic policy, the fundamentals of a national economy. Thus, for instance, while Mexico's 1994-95 economic crisis was signaled by cross-border capital flows, it was imbedded in the circumstances of the Mexican economy and was domestic in origin.

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The peculiar impact of financial globalization in circumstances where national economies are highly exposed to or integrated into the global economy is that whenever public policy makers ignore these constraints, globalization manifests itself in the form of "market discipline" applied to inconsistent, incompatible or flawed policies. Both Mexico's 1994 crisis and the British ERM episode indicate that misguided public policies that seek to change prices in the financial markets by fiat, not the powerlessness of national governments, were the major impetus behind these crises. Put differently, financial markets sanction national policies that are incompatible with or insupportable by real economic fundamentals or performance. Further, the sheer size, sophistication and dynamism of financial markets have compressed both the timing and severity of reactions to public policy mistakes, as evidenced by the *peso* crisis of 1994, Britain's ERM episode, global financial markets' reaction to Hong Kong and Southeast Asian currency crises, etc.

Regarding monetary policies, market reactions are sharp, quick and severe; regarding fiscal policies, it appears, a time lag is involved: Global financial markets enable national governments to borrow more and more cheaply than would otherwise be the case. However, if governments do not manage their budget deficits, the eventual punishment may be severe. This is especially true if governments finance current account deficits through dollar-denominated portfolio investments that could be quickly withdrawn. Indeed, this is one of the lessons to be drawn from the Mexico's *tesobonos* crisis of 1994.

The Asian contagion shows that large current account deficits financed by foreign portfolio investments that could be instantaneously withdrawn, and large net currency exposures coupled with constraints on exchange rate fluctuations are incompatible with long-term financial stability. Further, a fixed foreign exchange regime poses a dilemma for national authorities: Governments can not have both a fixed exchange rate and also maintain control over interest rates. A government that implements a fixed exchange rate regime should recognize that it is not likely to retain a substantial measure of control over interest rate policy. Conversely, to have control over interest rates, national authorities may have to forsake a fixed exchange rate currency regime. This is the dilemma that Britain faced in 1992, and was unable to resolve.

The ramifications for central banks and monetary policy is

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especially critical. Whereas expansionary monetary policy runs the risk of fueling inflation, and rising nominal and real long-term interest rates, a tight monetary policy reduces the ability of market participants to acquire the necessary credit needed to lubricate transactions in the economy. The challenge for national monetary authorities is to strike a proper balance between the two. Governments that issue debts, and guarantee the liabilities of depository institutions in the face of a large budget deficit risk downgrading of their sovereign credit rating. In this sense financial markets do exact a price for erroneous fiscal and monetary policies.

In short, a major implication of this study is that the current almost exclusive preoccupation in the literature with the extent of the loss of national economic sovereignty in the face of globalization is not helpful. It is more fruitful that scholarly research pays greater attention to the ways in which "public policy misalignments" or incompatible and unsustainable government policies trigger reactions in the global markets, how global market forces and national economic fundamentals interact and, as a result, identify and explain various types of constraints on the economic policies of national governments.

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International Migration and the "Brain Drain"

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The authors explore the nature of the international "brain drain" and provide details of the extent to which the poorer countries are losing their more qualified citizens to the "first world".

Key Words: International Migration, "brain drain", OECD countries, third world countries, developing nations, poverty.

Perhaps the oldest question in economics is why some countries are rich while others are poor. Economic theory has emphasized that differences in the educational levels of the population are an important part of the answer and that improved schooling opportunities should raise incomes in developing countries. Yet, while there is little doubt that highly educated workers in many developing countries are scarce, it is also true that many scientists, engineers, physicians, and other professionals from developing countries work in Canada, the United States, and Western Europe.[1] This phenomenon, often referred to as the "brain drain," was noticed as early as the 1960s and has been a contentious issue in the North-South debate ever since. One important implication of the brain drain is that investment in education in a developing country may not lead to faster economic growth if a large number of its highly educated people leave the country. Also, efforts to reduce specific skill shortages through improved educational opportunities may be largely futile unless measures are taken to offset existing incentives for highly educated people to emigrate.

But how extensive is the brain drain? Which countries and regions

[1] The authors of this article nowhere mention the fact that human abilities are to a large extent genetically-orchestrated. This, however, does not reduce the importance of their study, but on the contrary rather increases the significance of their findings. To the extent that there is any correlation between educational achievement and genetic endowment, any brain drain is likely to weaken the genetic potential of the country suffering from the emigration of its better qualified workers - Editorial comment.

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are especially affected? Do highly educated professionals from developing countries living abroad represent a sizable proportion of the pool of skilled workers in their countries of origin or too small a number to worry about? Unfortunately, attempts to answer these important questions quickly come up against a formidable barrier: there is no uniform system of statistics on the number and characteristics of international migrants. Also, source countries typically do not keep track of emigrants' characteristics; and, although some receiving countries do, their definitions of immigration differ. Thus, it is difficult to measure precisely the flow and levels of education of immigrants. Further, it has only recently become possible to measure the stock of educated workers in each source country – the pool from which brainpower is drained.

The Brain Drain from the OECD to the U.S.A.

Despite the lack of systematic data about international migrants, estimates of the stock of migrants by educational level in member countries of the Organization for Economic Cooperation and Development (OECD) can be constructed using a variety of data sources. The resulting estimates are less than perfect in many respects, but they significantly improve our knowledge of the magnitude of the brain drain. The study on which we based this article (Carrrington and Detragiache, 1998) covers migration from sixty-one developing countries accounting for about 70 percent of the total population of developing countries. Because of the lack of data, we have not attempted to estimate the extent of either the brain drain from the former Soviet Union and Eastern Europe, even though casual evidence suggests that it is substantial, or migratory flows among developing countries.

In our study we followed a two-step procedure: first, estimates of the brain drain to the United States were constructed using 1990 U.S. census data and other sources of information. Then, these estimates were used – together with data on migrants to OECD countries other than the United States drawn from the OECD's Continuous Reporting System on Migration – to estimate the extent of the brain drain to all OECD countries. While the resulting estimates should be reasonably precise for migration to the United States (which accounts for 54.3 percent of the total migration from the developing countries in our sample to all OECD countries), they are much more tentative for the brain drain to all OECD countries.

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The U.S. census reports whether individuals polled are foreign born and, if they are, their country of origin and the number of years of schooling received is also reported for each individual. After individuals under 25 years of age are eliminated to ensure compatibility with the data on educational attainment described below, all foreign-born individuals in the census are put into one of three broad educational categories: primary (0 to 8 years of schooling), secondary (9 to 12 years of schooling), and tertiary (more than 12 years of schooling). A further adjustment involves subtracting from the group of foreign-born individuals with a tertiary education all graduate students in U.S. universities, using data from the Institute of International Education. This procedure yields, for each developing country in the sample, the number of migrants in the United States in each of the three educational categories. To assess the extent of the brain drain from each country considered, these estimates must be compared with the number of individuals in each educational group who remain in their home country. Doing this requires a breakdown by educational category of the population of each developing country in the sample, for which we rely on a data set recently assembled by Robert Barro and Jong-Wha Lee (Barro and Lee, 1993), which provides the best estimates available to date of educational attainment for individuals more than 25 years of age in a large sample of countries.

Source Countries

The first striking feature of the U.S. migration data is that immigration flows of individuals with no more than a primary education are quite small, both in absolute terms and relative to other educational groupings (about 500,000 individuals out of a total of 7 million immigrants). Foreign-born individuals with little or no education, however, may be undercounted by the census if they are in the country illegally or do not speak English. The largest group of immigrants into the United States (about 3.7 million) consists of individuals with secondary education from other North American countries (understood here to include Central American and Caribbean countries), primarily Mexico. Perhaps surprisingly, the second largest group (almost 1.5 million individuals) consists of highly educated migrants from Asia and the Pacific. Total immigration from South America and, especially, Africa is quite small. It is noteworthy, however, that immigrants from Africa

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consist primarily of highly educated individuals (about 95,000 of the 128,000 African migrants).

Among the countries in Asia and the Pacific, the biggest source is the Philippines, with 730,000 migrants. Of these, the great majority have a tertiary education. The second largest stock of migrants is from China (400,000), which is split almost equally between the secondary and tertiary educational groups. Both India and Korea have seen more than 300,000 people migrate to the United States. It is striking that more than 75 percent of Indian immigrants have a tertiary education, compared with only 53 percent of Korean immigrants.

The biggest migratory flows from Africa to the United States are from Egypt, Ghana, and South Africa, with more than 60 percent of immigrants from those three countries having a tertiary education. Migration of Africans with only a primary education is almost nil. The picture is quite different for the migratory flows from the Western Hemisphere: Mexico is by far the largest sending country (2.7 million), with the large majority of its migrants (2.0 million) having a secondary education and fewer than 13 percent having a tertiary education. This pattern is also observed for the smaller countries of Central America, but not for the two Caribbean countries for which we have information, for which migrants with a tertiary education are a more substantial percentage of the total (42 percent for Jamaica and 46 percent for Trinidad and Tobago). Finally, migration from South America to the United States is relatively small in absolute numbers, with immigrants split almost equally between the secondary and the tertiary educational groups.

In each sending country, how do the numbers of emigrants compare with the size of the population with a given educational attainment? For most countries, people with a tertiary education have the highest migration rate, with the exceptions of the Central American countries, Ecuador, and Thailand (in Thailand, people with a secondary education and those with a tertiary one have approximately the same migration rates) (see chart). Thus, migrants to the United States tend to be better educated than the average person in their home (that is, the sending) country, and the proportion of very highly educated people who migrate is particularly high. Also, migration from Central America seems to follow a somewhat different pattern than migration from other developing countries, in that the highest migration rate is for persons with a second-

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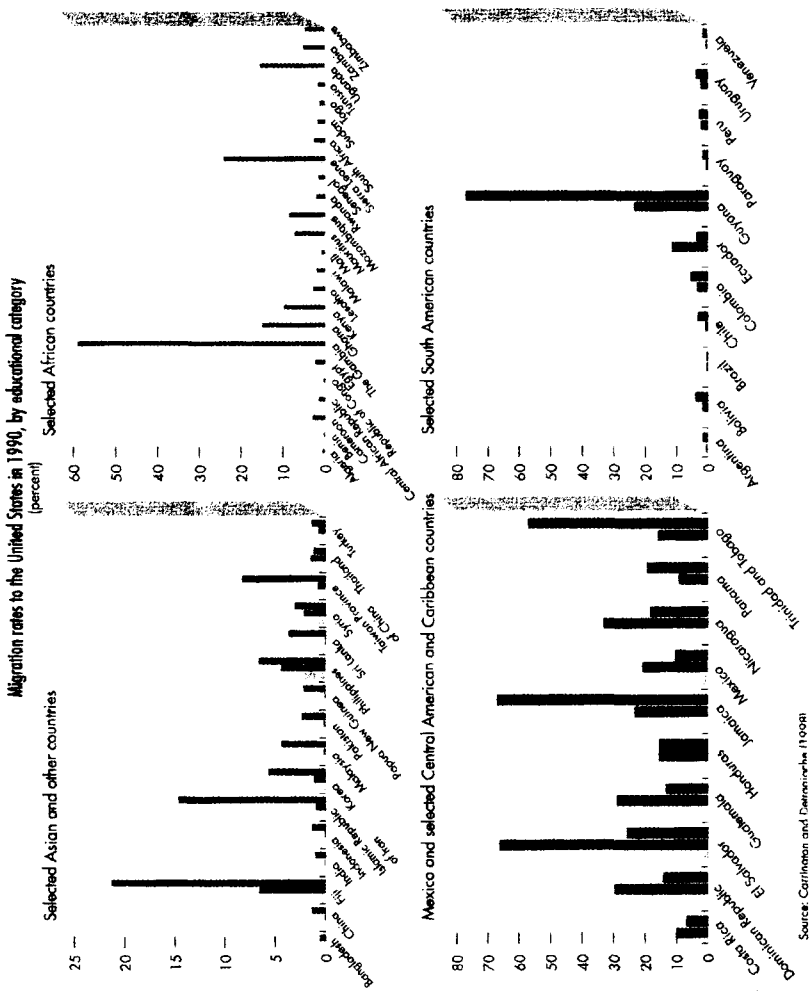

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ary education, rather than those with a tertiary education.

The brain drain to the United States from many Central American and Caribbean countries is substantial: for persons with a tertiary education, immigration rates for virtually all these countries are above 10 percent, and some appear to be 50 percent or even higher. In South America, the country with by far the largest brain drain is Guyana, from which more than 70 percent of individuals with a tertiary education have moved to the United States; for the rest of the region, the immigration rates for this educational group are much lower. The Islamic Republic of Iran has had a substantial drain of highly educated individuals (more than 15 percent) and so has Taiwan Province of China (8-9 percent).

Problems of Methodology

To construct estimates of the brain drain from developing countries to OECD countries, we have relied on the OECD Continuous Reporting System on Migration. Unfortunately, unlike the U.S. census, this data source does not report the years of schooling that migrants have received. For lack of any practical alternatives, we have assumed that the distribution of immigrants by educational category from each source country is the same for the United States as for other OECD countries. Although this is the only feasible approach, which often produces numbers that are consistent with anecdotal evidence, there are some instances in which it yields implausible results, particularly for countries with low rates of immigration to the United States but high rates to one or more of the other OECD countries. Immigrants to the United States from such countries are likely to be better educated than immigrants to other OECD countries, who thus may be more representative of the source country's population.

A second problem with the data for OECD countries other than the United States lies in the different criteria for classifying individuals as immigrants. Although Australia, Canada, and the United States define an immigrant as a person who was born abroad to noncitizens, most European countries define immigrant status based on the ethnicity or immigration status of the parent. A third difficulty with the OECD data is that they did not permit us to exclude immigrants under the age of 25. Finally, the OECD records immigrants from only the top 5 or 10 countries from which they come to each OECD country. Thus, for example, the OECD figures for Canada would include specific

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information on the numbers of immigrants from China and Mexico, but not those from Jamaica and El Salvador. This is a problem when emigration flows are significant for the source country but small for the receiving country. Thus, particularly for small countries, our estimates of immigration to OECD countries other than the United States may be seriously understated.

If, as a rule of thumb, we consider estimates to be unreliable when migrants to the United States account for less than one-third of the total of immigrants to all OECD member countries, then all estimates for immigration from the Asian and Pacific countries are reliable with the exceptions of those for Malaysia and Sri Lanka. Turkey is also an exception. Among the remaining countries, the extent of the brain drain to all OECD members is substantial – and it increases significantly compared with the U.S. data for the Islamic Republic of Iran, Korea, and, to a lesser extent, the Philippines For the Islamic Republic of Iran, the fraction of the population with a tertiary education living in OECD countries is around 25 percent; for Korea, 15 percent; and for the Philippines, about 10 percent. For Pakistan, the migration rate of individuals with a tertiary education is more than 7 percent, while for India it is about 2.7 percent; these figures, however, fail to take into account the sizable flow of professionals from the Indian subcontinent to Bahrain, Kuwait, Oman, Qatar, and the United Arab Emirates and therefore neglect an important component of the brain drain from the relevant source countries. The migration rate of highly educated individuals from China is about 3 percent.

For Africa, the estimates are unreliable for Algeria, Senegal, and Tunisia, from which migrants go mainly to France. For most other countries in the sample, however, migration to OECD countries other than the United States is quite small, so the results derived for the United States remain essentially valid. There are, however, some exceptions: for Ghana, the migration rate of highly educated individuals is a dramatic 26 percent; for South Africa, it is more than 8 percent; for Egypt, the brain drain includes 2.5 percent of such individuals emigrating to the United States and another 5 percent emigrating to other OECD countries. For countries in the Western Hemisphere, the bulk of migration is to the United States, and inclusion of flows to the rest of the OECD makes little difference. The only exception is Jamaica, which has a considerable stock of migrants living in the United Kingdom. The drain from Jamaica's

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population with secondary education is 33 percent, while that from its population with tertiary education is more than 77 percent.

Our estimates show that there is an overall tendency for migration rates to be higher for highly educated individuals. With the important exceptions of Central America and Mexico, the highest migration rates are for individuals with a tertiary education. A number of countries – especially small countries in Africa, the Caribbean, and Central Americalost more than 30 percent of this group to migration. We have also found a sizable brain drain from Iran, Korea, the Philippines, and Taiwan Province of China. These numbers suggest that in several developing countries the outflow of highly educated individuals is a phenomenon that policymakers cannot ignore.

Why the Brain Drain?

More research, especially empirical studies, is needed to evaluate the impact of the brain drain on source economies and on worldwide welfare, as well as the reasons for such migration. In regard to the latter subject, immigration policies in OECD countries tend to favor better-educated people, which may explain why the *educational composition* of total migration is skewed toward the better educated but cannot explain why so many skilled workers are willing to leave developing countries.

Wage differentials may be part of the explanation, but this raises the question of what accounts for such differentials. Differences in the quality of life, educational opportunities for children, and job security may also play a role, as may the desire to interact with a broader group of similarly skilled colleagues. Another important issue is the extent to which the benefits of education acquired by citizens of developing countries are externalities that individuals cannot be expected to take into account when making their private decisions. If such externalities are substantial, as is emphasized by the "new growth theory," then policies to curb the brain drain may be warranted.

Our research also indicates several ways in which estimates of the brain drain could be improved using existing data. The first would be to use census information for other large immigrant-receiving countries, such as Australia, Canada, France, and Germany. Together with the United States, these four countries account for about 93 percent of total migratory flows to OECD countries, so the resulting figures would be a very good approximation of the total. Another promising direction for

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future research would be to try to obtain, from census data or other sources, more detailed information about the occupational categories of highly skilled migrants, in order to assess whether the brain drain from a given country is especially marked for particular professional groups. This type of analysis could be useful for evaluating the problems that policy programs – such as health sector reform, financial liberalization, or civil service reform – may encounter in developing countries.

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Privatizing the Housing Sector: The Case of Kazakhstan from 1985-1995[1]

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In Kazakhstan the Soviet era ended with independence in 1991. One of the many transformations subsequently occurring was privatization; and one of the first arenas to be privatized was housing. This paper describes the housing situation during the Soviet regime, the economic and social processes as they relate to the construction of housing in the first few years since independence, the processes by which housing became privatized, and the nature of housing in the newly emerging markettransition conditions. The paper then concludes with issues yet to be resolved in the early years of deSovietization.

Key Words: Privatization, housing, Kazahkstan, post-Soviet era, market-transition.

Revolutions across the former Soviet Empire during the 1980s swept away the control of the Soviet Communist political party first in central Europe and later throughout the Asian republics as well. With the sudden disappearance of the legitimacy of state ownership, totalitarian political regimes, and centrallyplanned economics, newly forming societies throughout this region of the world were faced with the task of creating mechanisms for private ownership, market economies, and democratic processes. While the literature contains a variety of models for moving into totalitarian societies, no models are known which describe or predict the construction of new societies from totalitarian examples. Thus, scholars have continued to be intrigued by attempts made in these societies to solve the age-old problems of human commu-

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nity. One of the early decisions in most of these areas was to transform family housing from state owned status to private ownership. Mechanisms for the privatization of housing varied among former soviet societies, were developed through characteristics somewhat unique in each society, and typically generated consequences of mixed blessings as well. This paper examines the immediate impact of de-Sovietization by utilizing data from 1985 through 1995 and focusing on the processes of privatizing the housing sector in Kazakhstan during the early years of independence.

Housing Under the Soviet Regime

The Republic of Kazakhstan, the second largest of the former Soviet republics and the largest of the central asian republics, has a total area of 2,717,300 square kilometers (less than half the size of the U.S.). The population, however, is only 16,916,463 (July 1996) which is roughly one sixteenth of the population of the U.S. The average family size in 1989 was 4.0. About 56% of the Republic's population was urban, living in 83 cities and towns (8,000 or more population) and 202 "urban type settlements". These settlements were established during the Soviet era to be 2,000 or more population where 80-85% are workers (laborers who directly produce industrial products), employees (e.g., accountants, managers), and their families. Usually these settlements were for such special purposes as mining, refining raw materials, railway construction, and road construction. The remaining 44% of the population were classified as rural, primarily in 8,000 rural settlements.

The Soviet government built considerable housing units (usually high-rise apartment buildings) in Kazakhstan's urban areas for individual families. Most of this housing was built by stateowned enterprises and organizations. Those enterprises were obligated to spend part of their profits on social development projects; e.g., on such projects as the improvement of living conditions of employees by building dormitories and apartment buildings, on providing free kindergartens, and on maintaining free medical centers. Housing development was given special priority on both the national and company levels.

Apartments built by companies were rented to their employees and their families. First priority for the distribution of these apartments was need; i.e., people without housing or with unsatisfactory housing (according to official norms) were given first consideration. Other

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categories given priority for housing included seniority with the company; i.e., veterans of labor (40 or more years of employment), veterans of World War II or of the Afghanistan War, those with 20 or more years of military service, single-parent families (essentially mothers), families with many children (four or more), families with disabled children, young families (under 31-year-old spouses) with a child/children born during the first three years of marriage, employees of educational and medical systems, and others. These categories of employees were on the top of the "housing waiting lists" of enterprises and organizations.

The employees of construction companies usually received housing as a percentage of the houses they build for the stateowned enterprises included in their contracts. Housing for the employees of non-profit organizations such as ministries, police and military forces, and educational institutions were subsidized by the government.

The size of the apartment received by a family depended on the number of family members and the number, age, and gender of children. Children who were at least 18 years old and of different gender were to have separate rooms; in 1992 the age was changed to seven. The officially required norm for space-per-person has changed many times, first being 6, then 9, 12, and again 9 square meters per registered person. In 1998, it became 15 square meters per person.

Housing for the elite, however, did not follow such a formula. The elite of soviet Kazakhstan included the high administration of the Soviet Army, police, KGB, ministries, and other government agencies as well as artists, scientists, and others. Elites were able to obtain apartments directly (avoiding waiting lists) which were larger in size, of better quality, and were planned better regardless of how many people were in their families or any other characteristics.

People typically "owned" their apartments; that is, upon the death of the primary lessee, the apartment would be "inherited" by the spouse or, if no spouse, then by children so that family heirs could continue living in the apartment generation after generation. If there were no heirs, the apartment would be redistributed to other employees on the enterprise's waiting list.

The rent and utility payments were very low; in fact, the Communist Party repeatedly broadcast through radio, TV, and newspapers that the rent was the lowest in the world. According to Alazov (1980), rent and utility payments have not changed essentially since 1928 when they were

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set not to exceed 3% of the average working class family income. The payment of rent and utilities included payments for building maintenance and heating per square meter, payments for garbage, gas, hot water, cold water and sewage, and elevator use per tenant. Payments for local telephone calls, radio, and TV antenna were fixed. Payment of electrIcity was based on the actual use according to electricity meters. Rent was computed per both square meter and registered tenant. Registration of tenants living in an apartment at the local Department of Internal Affairs was required for all citizens of Kazakhstan. This mechanism was used to control urbanization processes and legal issues of housing and employment.

There had also been a small percentage of individual families who had built their own apartment blocks by organizing into co-operatives and pooling their savings. But still there were not enough housing units, and many people, especially young families, were on waiting lists for many years to obtain housing. This shortage resulted because state-owned industrial companies and government organizations did not have enough capital for housing development, and most of the working people could not afford co-operative apartments.

One of the ways for companies and organizations to solve the problem was to build dormitories as temporary housing for their employees. In some of these dormitories single employees or even a whole family lived in a single room. Other dormitories were designed as apartment blocks where small apartments would house families of 2-3 persons. Some dormitories were designed as rooms for individuals with common kitchens and bathrooms on each floor – but sometimes families lived in them as well. There were also some dormitories designed as "sections" where two or three rooms would have their own bathroom but share a kitchen with other sections. Each room was designed for two persons. In general a lot of people were housed in a little space. While dormitories were thought to be temporary, many people lived in them for many years, sometimes generation after generation.

In the rural regions of the Republic, organized into large collective farms, the housing situation was quite different. Most of the housing was individual family buildings and was private, either existing before the Soviets arrived or built later by the occupants. Only a few housing units in each collective farm were financed by the farm (by the government). These houses were typically rented to the farm's management. Hence, the

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quality and quantity of housing in the rural areas depended primarily on people's personal financial situations. Generally, housing in rural regions was much less likely to be supplied with running water and was less sanitary but considerably larger than housing in urban areas.

The construction complex of Kazakhstan was largely developed during the Soviet period in a relatively short time. Housing construction was given particular priority, especially in the 1980s. It reached its peak in 1988 when 8.9 million square meters of housing were built. The collapse of the Soviet Union in 1991 and the declaration of sovereignty by the former Republic started a new period in the development of Kazakhstan.

Construction Since Independence

The dramatic economic recession following independence greatly impacted the construction industry. Tables 1-4 summarize some of the socio-economic trends in the housing sector before independence (1985-1990) and after the break-up of the USSR (1991-1995).[2] These data show a gradual decrease in the proportion of state-sector housing and an increase in construction with private enterprises and individual investment.

As shown in Table 1, the number of apartment buildings increased from 6,627 to 7,869 units (in increase of 1,242 or 18.7%) during the last five years before 1991 but sharply *decreased* from 7,869 to 1,662 units (by 6,207 or 78.9%) during the next five years. In terms of sources of funding, the largest source of housing, enterprises and organizations, increased by only 9.8% (from 5,929 to 6,630) between 1985 and 1990. Housing funded by private citizens increased by 20.4% (528 to 1,164)

[2] The analysis is based on the data obtained from statistical publication of various Kazakhstani and international organizations. The Government Statistical Committee of the Republic of Kazakhstan (Goskomstat) and the Ministry of Finance are the most important sources of information. Goskomstat had served as the main provider of statistical information for government planning in the Republic during the Soviet regime. Under the planned economy, every enterprise and organization of any type and ownership was obligated to provide requested information to the Goskomstat. While this situation has changed in recent years, Goskomstat is still the only government agency which has the authority to request information and thus remains the main source of statistical information. Data obtained from different organizations and scientists, however, are not necessarily consistent

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during this time period; and housing in collective farms increased by 16.7% (from 150 to 175). In 1995, however, enterprise-funded construction was just 15.7% of its 1990 volume; collective farms were able to finance only 4.6% percent of what they had in 1990; and private citizens had cut housing investments by almost half (by 46.1% from 1990 to 1995). Still, the largest source of funding, by far, was state enterprises and organizations.

Table 1 also shows that housing construction had been more intense in urban areas of the Republic. For example, in 1985 55.6% of the housing construction was in urban areas (3,525 of 6,337 apartment buildings). By 1990 urban construction had increased to 62.4% and by 1995 to 74.3%. Correspondingly, housing construction in rural areas decreased from 44.4% in 1985 to 37.6% in 1990 and to 25.7% by 1995. Hence, rural construction suffered the most from the economic crisis in Kazakhstan beginning in the 1990s.

Table 2 presents data on the number of apartments and dormitory rooms built. This table shows again the dramatic changes since independence. From 1985 to 1990 there was an increase of 3.4% (from 110,300 to 114,000) units constructed and a dramatic decrease of 82.1% since 1990 (from 114,000 to 20,400). By funding category, enterprises and organizations decreased by 1.9% before independence and by 84.8% after independence. Units funded by private citizens increased by 87.1% and then decreased by 55.2% across the same time period; and collective farms first increased by 9.5% and then essentially ceased construction by 1995.

As can be seen in the bottom half of Table 2, the privatization of apartments/dormitories reached its peak in 1993 when almost a million apartments (47.1% of all state-owned apartments) in Kazakhstan became private. During the following years, the percentage of the remaining state-owned apartments which remained unprivatized decreased to 33.7% in 1994 and to 21.4% in 1995. So by 1995 there was little state-owned housing remaining. The process also proceeded more quickly in the rural areas. 55.6% of the privatized apartments were in rural areas in 1993 (compared to 44.4% in urban areas) and by 1994 36.4% of the apartments that were privatized were in rural areas (compared to 33.0% in urban areas).

The data in Table 3 show the same trends in housing construction in financial terms. As a percent of total capital investment in the

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economy, housing investments showed an annual increase until 1993, but then decreased gradually from a high of 24% of total capital expenditure in 1993 to 12% in 1995. Correspondingly, investments from private citizens peaked in 1993 and then trailed off through 1995. Both enterprise/organizations and collective farms, however, peaked in 1990 before decreasing sharply.

Table 4 contains data relevant to employment and income. The total number employed in the national economy steadily decreased across the years reported such that only 4,994,000 were employed in 1995 compared to 6,500,000 in 1985—a decreased of 23.2%. The number employed in construction, however, peaked in 1990 (an increase of 12.2%) before reaching an all-time low in 1995 (a decrease from 1995 of 56.4%). In terms of personal income, there was a steady growth in both monthly salaries and pensions which peaked in 1994 with a 1,253.5% growth in salary and a 721.2% growth in pensions from 1993. After 1994, salaries and pensions continued to grow, but the rate of growth slowed down to 177.3% for salaries and to 88.0% for pensions per year. One explanation for such a sharp increase in private income in the early 1990s is that the economic crisis was accompanied by a high rate of inflation/ hyperinflation. Inflation grew at approximately the same rate as the average monthly salary but at a higher rate than the average monthly pension (see Table 4). Even though inflation and the average monthly salary grew at about the same rate, it should be noted that inflation is calculated for all food, industrial products, and services. The rapid rise in prices for food, however, was particularly dramatic.

There were great shortages at this time; such food as butter, oil, sugar, vodka and other basic products could only be obtained with government-issued coupons. These coupons were distributed to enable each person to buy only a very small amount of these products. In addition, prices for construction materials have increased since 1994 at almost twice the rate of all foods, consumer, and industrial products (see Table 4). Since the beginning of reform (1991), prices have increased 19,300 times; since the establishment of the Kazakhstani currency (tenge) in 1993, price increases have slowed to only 37.4 times.

In 1995, the average housing allotment in the Republic was about 15 square meters per person while the officially-approved norm was 18 square meters (United Nations, 1996). Comparing urban and rural indicators, the average city resident had 16.3 square meters of space

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while the average rural inhabitant had only 13.4 square meters. The relatively high level of housing in Kazakhstan, however, was still far behind that in European countries by 30-50 square meters (United Nations, 1996).

The Housing Privatization Process

The housing privatization process initially began before independence in 1988. Most of the old housing was to be privatized without any capital renovation due to the steady reduction of state subsidies. After independence, the New Housing Code (1992), the President's Decree on Rights for Housing (1994), and the Law on Individual Residential Construction (1994) were adopted. These acts are intended to regulate the housing market in the context of the drastic reduction of state subsidies for residential construction. These acts specified plans for converting housing to individual owners and began with the concept of differentially rewarding individuals for their contribution to their motherland, expressed as the number of years of employment or of being a student in higher learning. Each citizen would receive a certain amount of "housing privatization coupons" based upon the total years of employment or years of study before 1992. Students received coupons because in the former regime years of study were counted in their employment history for various purposes, such as pension entitlements, which were organized on a "pay-asyou-go" system. The employment history is part of each person's permanent record in his/her Labor or Employment Book (each person's Trudovaya Knizhka). This official document contains the following information: (1) personal data – last and first name, patronymic, date of birth, education, profession, and specialization; (2) employment history – date of hiring, of position changes, and of resigning; (3) records of awards and honors; and (4) records of discoveries, inventions, and "rationalization" initiatives. All records are completed by the administration or personnel departments of companies, authorized with the corporate seal, and kept by the employer until retirement or resignation. Consequently, the current employer is then responsible for authenticating statements of their employee's total years of employment.

Each year of employment is rewarded with 400 coupons. Students of higher education receive 200 coupons for each year of study; children do not receive any coupons. Each coupon is equal to one ruble for

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privatization purposes. The market value of these coupons is zero because the government prohibits selling as well as buying these coupons. The accumulated coupons are then to be deposited in the employee's special coupon account or a joint account with their family in the state-owned Kazakhstan Saving Bank by the end of 1993.

The next step in privatization is the estimation of the apartment's selling price. The original price of each apartment and its amortization during the Soviet period are considered in this estimation. Also, the location of the apartment building in the city (ecological situation) and location of the apartment in the building (the floor) are given special consideration. For example, if a family or person lives in an ecologically clean region and their apartment is located on the second or third floor of a four-story building, they would pay the full price of the apartment. If people live in worse conditions, they would have a discount of a certain percentage of the apartment price for these environmental conditions. The estimation is then implemented by the Bureau of Technical Inventory (*Buro Tekhnicheckoi Inventarizatzii*) which was established by the government to work in rural areas with the Executive Committee of the Local Soviet People's Deputies (the Ispolnitelnyi Komitet Mestnykh Sovetov Narodnykh Deputatov) in urban areas to administer the housing privatization process.

The final stage is payment for the privatized housing which is controlled by the regional Housing Department. On the basis of the amount of credited coupons and the estimation of the housing's value by the Bureau of Technical Inventory, the Housing Department determines how much each family should pay for its apartment. Since one coupon equals one ruble, the payment mechanism is very simple: a family subtracts the amount of credited coupons from the determined selling price of the apartment. If the difference is negative, the family must pay the difference with cash. If the difference is positive, the family can participate in the Small-Scale Privatization Program (to be discussed later) with their excess coupons. Most of the apartments which are at least 10-15 years old are bought with coupons only. But newer apartm-

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Figure 1. Privatizing mechanism of an illustrative apartment.

Consider an average two-bedroom apartment, which has 62.9 sqare meters of total disposable space built by the prefabricated concrete paneling technology in 1973 when its cost would have been 570,500 Rubles. The apartment is located on the third floor of a four-story building. The building is in an ecologically clean region of the city. The privatization year is 1992.

Original price in rubles		570,500.0
Amortization for 20 years at 1.8%	570,500 – 195,111 =	375,389.0
Total square meters of the building is 4,704	375,389 / 4,704 =	79.8
Ecology rating of 1 (1.2 correction ratio)		
Floor rating of 1 (1.7 correction ratio)		
Price of 1 square meter with correction ratios		162.8
Total square meters of the apartment = 62.9		
Selling price in rubles	62.9 * 162.80 =	10,240.0

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Our illustrative family consists of 2 parents and 2 children (a schoolgirl and a university student). The family has a joint account of privatization coupons.

Family Member	Total Years of Credit	Number of Coupons
Father	28 (28 * 400 = 11,200)	11,200
Mother	25 (25 * 400 = 10,000)	10,000
Schoolgirl	0	0
Student	4 (4 * 200 = 800)	800
Total for the family		**22,000**

Hence, the family pays the whole price of the apartment with their coupons. Moreover, the family has an excess of coupons (11,760 coupons) that can be used in the Small Privatization Program. After the privatization, every member of the family owns 1/4 of the apartment.

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ents usually require cash in addition to coupons. Some people, however, are exempted from paying the cash portion of their apartments; these exemptions include military officers with 20 years of service, military personnel who have served in foreign wars, family members of military personnel killed in action, and pensioners.

This mechanism for privatizing housing established by the Bureau of Technical Inventory is illustrated in Figure 1. This illustration is of an average two-bedroom apartment with 62.9 square meters built by the prefabricated concrete paneling technology in 1973. The building is in an ecologically clean region of the city (ecology rating = 1), and the apartment is on the third floor (floor rating=1). The price of the entire apartment building was determined to be 570,500 rubles. The building is amortized for 19 years at 1.8% generating a discount of 195,111 rubles for 1992. Then the current value of the building is divided by the square meters of the building (570,500 – 195,111 = 375,389 / 4,704 = 79.80). The price per square meter is then multiplied by 1.2, the result of an ecology rating of 1, and then by 1.7, the result of a floor rating of 1 (79.80 * 1.2 *1.7 = 162.80). The price of the apartment is then determined by multiplying the square meters by the corrected price per square meter (162.80 * 62.9= 10,240 rubles). The family in this illustration consists of a father who worked for 28 years (28 * 400 = 11,200 coupons), a mother who worked for 25 years (25 * 400 = 10,000 coupons), an elementary school girl (0 coupons), and a student who studied four years at a university (4 * 200 = 800 coupons). The total family credit, then, would be 22,000 coupons. The excess of coupons (22,000 – 10,240 = 11,760) can be used in the Small-Scale Privatization Program.

While the above mechanism for privatization is used in most cases, some categories of workers are eligible to receive free apartments for their private use. These categories include medical employees and teachers at all levels of schools who have at least a 10-year employment history in the field, participants in World War II, disabled soldiers, victims of the Chernoble events, and victims of Semipalatinsk and other nuclear test sites. In addition to free housing, all of these categories of people receive free housing coupons to participate in the Small-Scale Privatization Program. The one exception is employees of the educational and medical systems with ten or more years of service, these people and members of

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Table 1. Apartment buildings in thousands of square meters by source of funding and urban/rural areas, 1985-1995

	Year				
Apartment buildings	1985	1990	1993	1994	1995
Total apartment buildings	6627	7869	3856	2322	1663
By sources of funding					
Enterprises and organizations	5949	6530	2732	1529	1027
Private citizens	528	1164	1057	764	628
Collective farms	150	175	67	29	8
By urban/rural areas					
In urban areas	3815	4909	2258	1458	1226
Enterprises and organizations	3525	4315	1729	1042	851
Private citizens	280	587	529	416	375
Collective farms	10	7	–	–	–
In rural areas	2812	2960	1568	864	437
Enterprises and organizations	2424	2215	1003	487	176
Private citizens	248	577	528	348	253
Collective farms	140	168	67	29	8

Source: 1995 Statistical Yearbook of the Republic of Kazakstan, 1996

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Table 2. Number of apartments built by source of funding and urban/rural areas and privatization in number and percent, 1985-1995

Apartments and dormitories	Year				
	1985	1990	1993	1994	1995
Total apartments and dormitories (in thousands)	110.3	114.0	48.2	28.8	20.4
By source of funding					
Enterprises and organizations	102.0	100.1	38.2	21.8	15.2
Private citizens	6.2	11.6	9.4	6.7	5.2
Collective farms	2.1	2.3	0.8	0.3	0.0
Number of apartments privatized (in thousands)	--	35.9	977.9	401.1	94.1
In urban areas	--	23.4	696.8	314.1	80.1
In rural areas	--	12.5	281.1	87.0	14.0
Apartments privatized as a percentage of total amount of state-owned apartments at the beginning of the year	--	1.5	47.1	33.7	21.4
In urban areas	--	1.4	44.4	33.0	23.5
In rural areas	--	1.5	55.6	36.4	14.4

Source: 1995 Statistical Yearbook of the Republic of Kazakstan, 1996

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Table 3. Housing investments in million of Tenge*, 1985-1995

Housing investments	Year				
	1985	1990	1993	1994	1995
By source of funding					
Enterprises and organizations	2405	3656	1440	575	341
Private citizens	107	320	370	64	34
Collective farms	74	82	10	3	1
Housing investments as a percentage of total capital investment in the economy	16	20	24	11	12

**In prices of 01/01/91*

Source: 1995 Statistical Yearbook of the Republic of Kazakstan, 1996

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Table 4. Number of employed, average monthly salary/pension, and inflation, 1985-1995

Indicators	Year				
	1985	1990	1993	1994	1995
Number employed in the Kazakstan National economy (in thousands)	6500	6476	5630	5415	4994
Number employed in construction (in Thousands)	664	745	492	391	325
Percentage employed in construction	10.2	11.5	8.7	7.2	6.5
Average monthly salary in rubles through 1990 (in tenge since 1993)	186.5	265.4	(30,213.3)	(106,393.3)	(356,101.2)
Average monthly pension in rubles through 1990 (in tenge since 1993)	70.1	101.7	(28,791.5)	(61,516.7)	(139,583.3)
Inflation (in percent of the previous year)					
All food-stuff, consumer and industrial Products	–	--	2265.0	1258.3	160.3
Construction materials	–	101.5	182.0	2490.7	297.5

Source: 1995 Statistical Yearbook of the Republic of Kazakstan, 1996

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their families can either receive their apartments free or receive coupons. Workers of the agricultural sector of the economy, compared to industrial sector employees, have privileges as well in the privatization. However, the residents of new or relatively new apartments, usually young families, have to pay partially with coupons and partially with money. Since the prices for new apartments are relatively high and the amount of the privatization coupons is usually too small to cover the price, most young families have to pay for their housing with some money. Certain categories of people who do not have enough coupons to pay for their apartments have the cash portion waived; these categories include military personnel who served in foreign wars, members of the families of military personnel who died in war, military officers with at least 20 years of experience, and retired people on pensions.

Residents privatized some dormitories, especially the ones that were built in the apartment manner. Usually, these residents were on their enterprise's waiting lists for housing. After the privatization, they were taken off the lists as people with satisfactory housing conditions. In this way, the government was able to solve the housing problem at least for some people.

Housing privatization is a part of the larger process of privatization of state ownership in Kazakhstan. There are three more programs: (1) the Small-Scale Privatization Program which specifies the sale of small units such as small stores, service shops, and storage houses, (2) the Mass Privatization Program for the transformation of state-owned industrial enterprises into jointstock companies and the sale of their stocks to the population through special privatization investment funds, and (3) the Case-By-Case Privatization Program which identifies a special mechanism for the privatization of large state-owned enterprises which are vital for the Republic's economy or are monopolies in the internal markets of Kazakhstan.

The privatization of housing is closely connected to the Small-Scale Privatization Program. If a family or person has an excess of coupons during the apartment privatization, their excess coupons, together with cash, can be used to buy a small store, a storage house, a service shop, or some property of state-owned agricultural enterprises. In the first three cases, the price must be paid with coupons (50%) and cash (50%). But in order to encourage the development of agricultural farms and

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enter-prises, these properties can be privatized with a ratio of 75% coupons and 25% cash. Most of the Kazakhstanis, however, cannot participate in the Small Privatization Program because of a shortage of coupons and/or cash. These people, then, can sell, give away, or barter their housing coupons to other private citizens or private companies usually at very bargain prices. The Kazakhstan Savings Bank also can buy housing coupons from citizens, but the price is to be established jointly by the Government Committee of Property and the Kazakhstan Saving Bank; this price also is usually quite low. If people wish to use their coupons in the Small Privatization program during 1993 and 1994, they had the right to buy their apartments with cash. In this case, the apartment price was computed as of January 1, 1991.

Citizens are not given a choice in whether to buy their apartments; nothing on this issue is contained in any document examined. In the Soviet era, citizens had to obey government orders, and officials could find many ways to force compliance. Now, most people think it is in their best interest to become the owner of their apartment. They believe that virtually no one will get an apartment free anymore; so the prevailing idea is to take what the government is giving them almost for free.

Housing in the Market-Transition Conditions

Today, apartment owners' cooperatives (called KSKs) are being established to replace the former state-owned enterprises responsible for residential houses. These new cooperatives are free to recruit specialists to do renovations, provide services, and conclude contracts with specialized enterprises. As of January 1997, 600 KSKs have been established in the Republic.

In addition, new owners in the privatization process are free to sell, give away, rent out, or barter their apartments. Hence, people without homes can acquire an apartment today or have one built if they have enough money. But there are virtually no enterprises and organizations building houses for their employees any more.

According to the Committee of Statistics and Analysis of the Agency of Strategic Planning and Reforms of the Republic of Kazakhstan, the annual income per capita in Kazakhstan increased 1.2 times during 1997 to end at 34,097 tenge (which is roughly 445 U.S. dollars). That is, the average monthly income per capita was 2,835 tenge ($37 U.S.) which is lower than the official monthly cost of living. The annual

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expenditures per capita are listed as 33,193 tenge ($434) of which 55% is for paying utilities.

According to the results of a survey conducted by the Almaty Association of Sociologists (BRIF Center, 1997), almost a third of Almaty residents spend their monthly total income to purchase food products; and 57% of them report that they spend two-thirds of their monthly income on food. For 52% of the respondents, their wages are their only source of income. Only one in six of them reported some permanent additional source of income; and less than 5% ran their own business.

The buying power of Kazakhstanis is much lower than housing costs. The price for a standard one-bedroom apartment of 45 square meters, for example, exceeds the average annual income of citizens by 10-15 times. The illustration in Figure 1 of a 25-year old, two-bedroom apartment in a panel block building in Almaty actually cost $12,000 (U.S.) in 1998 (as set by the Bureau of Technical Inventory which calculates actual expenses required to build the structure in the present market). But its current market price is $15,000 and is likely to continue to increase. A nine-year old, one-bedroom apartment in a brick building in the same area of the city has about the same price set by the Bureau of Technical Inventory; but because of its better quality and planning, its market value is about $17,000 to $18,500. Market forces are beginning to determine housing prices.

Another social problem that emerged with the transition in Kazakhstan to a market economy is the problem of utility payments. The former Soviet system of payment for utilities based on square meters and number of tenants registered in an apartment no longer works in the new market conditions. There are extremely few meters installed to measure the consumption of gas, hot and cold water, and heating; there are only meters for electricity from the Soviet days. In addition, local municipal budgets also cannot/do not pay arrears of individuals to public utilities.

Monopolies of utilities companies in Kazakhstan is another source of problems. For example, `Kaztelecom', a joint-stock company with 40% of its stocks belonging to the South Korean company `Daewoo', is the only company for making telephone calls within the Republic. During the last year alone, prices for local, long-distance, and international calls increased by 60%. Another increase of 26% occurred in April of 1998. In addition, `Kaztelecom` has a license on exempt rights on

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long-distance and international calls for the next 15 years, and a monopoly right on wireless communication services, probably a most lucrative business in the near future.

During the Soviet era, neighboring republics (Russia, Uzbekistan and Turkmenistan) supplied gas to Kazakhstan. After independence and the resulting shortage of money, whenever Kazakhstan could not pay for gas, Russia stopped providing it. Still today, Kazakhstan has gas shortage crises. During the last few months of winter in 1998, the gas was turned off. Without gas, people can not cook food at home and are without heating. Today, the Kazakhstani government and the Belgian company 'Tracktebel' (the gas monopolist) blame each other for not observing contract conditions to provide gas. But the problem has not been resolved by exchanging Soviet centralized planning by private monopolies in the utility sector.

According to a public opinion poll in 1997 (BRIF Center), about 78% of the inhabitants of the largest city in Kazakhstan, Almaty, expect further increases in payments for their housing and utilities in the near future. Only about a third of them (34%) consider this measure as inevitable; 23% think that the rise in household costs is the result of disastrous economic policy; and another 12% are sure that the rise could be avoided if the monopoly of communal service providers did not exist. For example, during the last two years monthly house maintenance and utility payments in Almaty for the two-bedroom apartment illustrated in Figure 1 increased 3.5 times and has reached the level of about 2,800 tenge ($37). This is slightly less than the official minimum cost of living for one month which is about 3,000 tenge ($39) (Committee of Statistics and Analysis, 1997). Utility payments, however, vary greatly across the Republic, with some areas costing as much as seven times more. The national average is 3,430 tenge for a two-bedroom apartment with four registered tenants as of September, 1997.

There are also new fees and charges emerging, such as a new property tax (currently less than 1% of the property value) and a land fee which is now charged for each apartment. Apartments have become private but the land on which the apartment building stands is still a state property.

While housing payments almost reach the level of the official minimum cost of living, 60% of the citizens live below this level (Committee of Statistics and Analysis, 1997). Moreover, the continuing

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economic crises at both the national and local government levels have led constantly to late payments of salaries and pensions, sometimes by as little as 1-2 months or by as much as 1-2 years. As a result, many poor families, and especially retired people, have to sell their apartments, exchange them for smaller ones, or move in with family members in order to decrease their housing costs (payments are still based on apartment size). State construction of housing has dramatically decreased since 1993 and private construction is extremely expensive. Hence, the distribution of housing among various social strata is changing in favor of the prosperous.

Issues Yet to be Resolved

As a result, one of the major problems yet to be solved in the first few years of privatization is to establish mechanisms for providing favorable housing credit for the population at large. The majority of families without housing had neither enough money nor coupons to participate; and their level of income did not appear to ever be able to generate enough savings. Secondly, the government, specifically the Antitrust Committee, may need to reassess its relationships with "natural monopolist companies" such as "Tracktebel" and "Kaztelecom." Payment, or non-payment, for utilities remains a major problem. The failure of the government to meet its payroll (including pensions) for months, even years, left large numbers of families without income to pay even utilities. Even the government was a debtor to the newly privatized utilities. Thirdly, owners of privatized apartments need some new legal safeguards to protect their interests. Common space in apartment buildings (such as hallways, stairs, entrances, and in some cases kitchens and even bathrooms) had not been resolved in the privatization plans – nor had the ground on which the building stood. It was unclear what was owned or could be "sold", indeed, could the property itself be sold (certainly not the ground on which it stood) or simply the right to residency; or was this just a continuation of the "long-term leases" during the Soviet era? Will private housing become alienable; will banks eventually accept them as collateral? A fourth consideration is a reorganization of the utilities accounting system. The installation of utility meters is needed and might help reduce housing and utility payments. Finally, there could be an increase in housing construction if frozen constructions were revived and non-budgeted funds were allowed

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to be used along with the establishment of long-term credits to citizens to finance housing.

There was little hope that these issues would be resolved in the foreseeable future. Politicians give deference to staying in office, and there are many pressing problems competing for scarce resources. The privatization of housing, like other reforms underway in Kazakhstan, will probably continue to move in unpredictable directions as a consequence of the chaotic relationship continuing in such areas as the banking system, taxation policies (and tax collection), contracts (and their enforcement), foreign investment, and the interrelationship between former Soviet republics.

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BOOK REVIEW ARTICLE

The Andean Cocaine Industry
Patrick L. Clawson and Rensselar W. Lee III
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The Andean Cocaine Industry

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Criminal activities are not normally considered as a contributor to national income, yet the cocaine industry in the Andean countries (Peru, Bolivia, and Columbia) are important enough to be a major part of their national economies, as this fascinating book documents. Cocaine exports (cocaine is primarily an export industry) are estimated to be 53% of Peru's exports in 1992. For Bolivia, U.S.AID estimates had put cocaine exports as 90% of the exports in 1988, but "only 23%" by 1992. For an illegal activity, these are high figures.

The structure of the industry consists of large numbers of peasants growing the crop in low-lying and jungle areas, and with processing in "laboratories" located in the rural areas. The per capita incomes derived at this stage are low. The big profits are made by smuggling the drug into the U.S. and Europe. Estimates are that cocaine hydrochloride costs $1000 per kilogram, with the cost of transportation to the United States market being $3,000, and miscellaneous other costs (handling, bribes in major markets) $500. With a wholesale price estimated at $13,000 per kilogram in the U.S. market, the profit potential is very high. Getting the proceeds back home in legal form is estimated as costing 15% of the total, leaving the gross profit margins from shipping to the U.S. at $6,500 per kilogram, about half of the wholesale proceeds. Interestingly, European prices appear to be much higher at $35,000 per kilogram.

With the retail price of cocaine being $120-$151 per gram, the retail price is $121,000-$151,000 per kilogram, about 10 fold higher than the

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port-of-entry prices. Thus most of the cocaine profits are made in the United States, creating a strong incentive for the Colombian exporters to move operations downstream. In many U.S. cities Colombians have established distribution cells that sell the cocaine in lots of 30 to 100 kilograms at prices of $35,000 to $45,000. These highly profitable operations are run by immigrants from Columbia with strong ties back home (having relatives whose location is known to the exporter is one way of assuring loyalty). Since it is not known how many of these will eventually return home, it is unclear in national income accounting terms how much of this income should be credited to Columbia.

Estimates by Colombian economists of their country's cocaine income differ widely from as low as $170 million to $3.1 billion. One table (p. 24) puts exports by core Colombian organizations (i.e. excluding the small organizations not affiliated with the major Cali or Medellin-centered groups) at 250 tons to the U.S., and 80 tons to Europe, with total earnings of $3.71 billion. Due to higher prices in Europe, most of the earnings were actually from Europe. Estimating the major exporters as accounting for 75% of the exports, the total value of exports would be $8 billion. This substantial sum is 90% of the country's merchandise exports (recorded) in 1994, and 380% of the coffee exports (the leading agricultural export). The value-added proportion of this can be estimated at four to five billion dollars, which is equivalent to 8 to 9% percent of Colombia's 1994 GDP.

While not discussed in this section, it is likely that much of this income is held abroad (Swiss bank accounts etc.) due to problems in money laundering and in spending the vast per capita incomes earned by the estimated 500 individuals who stand at the apex of the industry.

The industry emerged in the 1970's with early traffickers smuggling small amounts in personal luggage. This system was organizationally simple. This small-scale system was replaced by fleets of small airplanes operating from rural airstrips that could carry 400 to 1000 kilograms, and later by large-scale smuggling in cargo containers, ships, etc. These systems required large organizations and sophisticated management. One organizational innovation was insurance. Pablo Escobar pioneered the system. For about 10% of the U.S. wholesale price, he replaced lost shipments (of course at the Colombian purchase price). If one looks at the numbers reported earlier in the book, this would imply paying $1300 in insurance for the privilege of receiving $1,000 if a shipment was lost.

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This would be sensible only if credit was extended for all or most of the payment. Then it might make sense since it would protect a small trafficker (or his financiers) from being wiped out by a lost shipment. Of course, for the insurer this was a highly profitable business, since most shipments got through. This "apuntada" system also made it possible to acquire financing from businessmen with clean records. If the shipment was successful everyone made money; if not, they were insured.

The newer, high volume shipments were successful enough to reduce the U.S. wholesale price from about $45,000 per kilo in 1982 to about $10,000 from 1988 on.

Although it is traditional to refer to Cali and Medellin "cartels," these were not cartels in the sense of groups that set prices. Instead they were allied groups of independent organizations, each with its own planes, etc. The two groups differed in some ways. The Medellin group, under the leadership of Escobar, has the more dramatic history. In behavior that is unusual for criminal organizations, he and others tried to use their drug money to launch political careers, relying on very generous distribution of money among the poor. This attempt failed and drew media attention to the source of their wealth. This publicity led to stronger government efforts to suppress the trade.

This was followed by a very violent phase of large-scale assassinations, with almost 500 policeman and 40 judges killed. Judges had the proverbial choice of "plomo" (lead, in the form of a bullet) or "plata" (silver, as a bribe). This system, not surprisingly, made it very hard to secure convictions in Colombian courts (which made extradition to the U.S. the principal threat to the traffickers). This went along with assassinations of higher political leaders who opposed them.

However, this blood-letting destroyed political support (much of which had been purchased by aid to the poor and other charitable acts) and led to an aggressive government campaign, which eventually eliminated the leadership of the cartel. With the start of the government's aggressive campaign, the cartel effectively declared war, and embarked on a bloody program of bombings (40 car bombs killed 500 people and one airplane bomb killed 119). They also kidnapped relatives of establishment figures in a deliberate attempt to force the government to give way to their demands.

Columbia is probably the only place where the criminal groups have been well enough organized to be able to negotiate with the government

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regarding a surrender. No formal agreement was reached, but there were a series of high-level meetings where proposals were discussed, and a stream of proposals from the drug group leaders referred to as the "Extraditables". These were the large-scale drug exporters who were in danger of extradition to the United States. Although many Americans view our justice system as relatively soft, and the prisons as comfortable, the threat of extradition to the United States (where they would be tried for the importation of cocaine into the U.S.) was a great concern to them. The reason was that by a combination of threats and bribes, the upper-level leaders could frequently be acquitted in a judicial proceeding in Columbia. A promise of no extradition was one of the political goals of the drug cartel. Thus, on four occasions (1984 to 1990) the leaders of the Medellin traffickers offered to leave the cocaine business and relinquish assets used in the business (laboratories, plants, and airstrips) to the Colombian government in exchange for an end to extradition, and a general amnesty. No agreement was reached.

However, this was followed by the adoption of a softer government policy towards the Extraditables in which they were promised protection from extradition and reduced sentences if they surrendered. They were required to confess to only one violation, and not required to inform on their colleagues. This produced surrenders of many of the highest leaders. The gain for those surrendering was both a reduction in the penalties they would probably pay if tried, and relief from the pain of a life on the run. The first major trafficker to surrender, Fabio Ochoa, testified to the pressures, saying, "I feel the same happiness entering jail as some else feels when leaving it - I only wanted to end the nightmare my life had become."

The major event was the surrender on June 19, 1991 of the leader of the Medellin cartel, Jorge Pablo Escobar. He was imprisoned in a newly built prison, La Catedral, that was on land he had once owned (and exchanged with the town administration for other land just 50 days before his surrender) overlooking his home town. The conditions negotiated for his surrender included the location of his imprisonment (in a town where he had great influence, partially from donations he had made), and that he and his representatives screen the guards. The prison was comfortable enough (having a bar, lounge, sauna, and other amenities). Perhaps more importantly it had fax machines, cellular telephones, and computers, permitting him to communicate with subordinates and continue running

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his illicit businesses. Known drug dealers and assassins were allowed to visit. Even more amazing, he was allowed to leave prison on occasions, such as for a major soccer game, with the police providing security.

The publicity given to this (his prison was referred to in the press as Envigador's five-star hotel) eventually led to the government deciding to move him to a maximum security facility, and ordering an army unit to occupy the prison. During an unexplained fifteen-hour delay in carrying out the order, Escobar and nine others escaped (obviously suggesting high-level corruption). This was followed by the government removing the army commander, the head of the police, and others.

After the escape, the government launched a search for him and associates with large rewards (i.e. $7,000,000 from the government and another $5,000,000 from a group composed of his enemies, many from the Cali cartel). This resulted in his eventually being killed in a shoot-out. Earlier his principal associates had either been killed or sent to jail. This greatly reduced cocaine sales by the Medellin group, from 70-80% of the total to 10 to 20%. Some in the group still remained in business.

In contrast, the traffickers in Cali pursued a less aggressive strategy, trying to obtain security through bribes rather than terror. However, they remained willing to employ violence against enemies, including rival traffickers.

While the very wealthy traffickers who bring the cocaine into the U.S. or Europe receive little sympathy, the majority of the people who make their living off of cocaine are the several hundred thousand coca leaf growing peasants. Although coca chewing is long established in the Andes, it is areas of new cultivation that supply the traffickers. These have attracted settlers from the overpopulated highlands. The coca bush grows on tropical slopes, and such lands are often unsuited for other crops.

Although direct substitution of another crop on the lands is often not practical, substitution through shifting to another crop on other lands is often possible. The U.S. finances a program to give the peasants alternative income sources. Because the coca growing areas are remote (the high per pound value of coca leaves makes their transportation economically feasible), alternative crops are frequently not economical. The local market for food crops is often the people engaged in the coca trade, so a successful anti-cocaine program would reduce the demand for these food crops. These are frequently not profitable to export outside of

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the growing region.

Frequently coca is so profitable that other crops cannot compete. A table showing the per hectare profits from different crops in Columbia shows coca to yield $1,784 per hectare, while the next most profitable crop is coffee at $308 per hectare. Only the opium poppy (illegal also) at $4,615 per hectare is more profitable.

However, for Bolivia, coca yielded $5.34 per worker day, which was less than the amounts yielded by bananas ($6.60), citrus ($6.53), and black pepper ($9.05). The clear winner was pineapple, which yields $16.80 per day, although its high capital cost ($5,068 per hectare) would deter many farmers. The approximate accuracy of these calculations is supported by the observation that Bolivian farmers have been producing more bananas and pineapples, and less coca.

The U.S. government has encouraged various crop substitution programs, and also programs that involve paying farmers for destroying their coca crops. The latter has run up against the problem that old fields (where the yields are low) may be destroyed, producing a relatively small output reduction. Also, given the extremely large area suitable for growing coca, eradication of one field may merely result in the farmer opening another one elsewhere.

Interestingly, although the fields may be efficiently destroyed by aerial spraying, the growing countries have had trouble getting the pesticides from the U.S. because the manufacturers feared product liability lawsuits.

The book points out that while crop substitution programs may be relatively ineffectual, some such programs may be politically necessary if the Andean countries are to be persuaded to vigorously suppress the trade. Many peasants depend on coca leaf for their livelihood, and it is hard to act against their livelihood, especially when those hurt by the trade are primarily outside of the country. Cocaine addiction rates are much lower in the growing countries than in the U.S., so the cocaine problem is viewed as a foreign one.

One of the more apparently successful programs involved the U.S.'s use of radar (Operation Support Justice IV) to help interdict planes bringing paste and other coca products into Columbia. This ran into problems when Peru shot a plane down. The Defense Department lawyers concluded that shooting planes down violated the 1944 Chicago Convention on Civil Aviation, which the U.S. had signed. They thus

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stopped supplying information from these radars to the Colombian and Peruvian governments.

Later Congress modified the law to make it clear that sharing intelligence information was legal. Once cooperation was resumed, the program appeared successful, with 23 planes forced down or destroyed on the ground, and a 47% decline in the number of narcotics flights. The increased interdiction produced a 89% drop in coca leaf prices, and a 88% drop in coca paste prices.

The authors discuss various other topics, such as the role of the cocaine trade in supporting guerrilla movements and the impact of the trade on the economy and politics of Columbia. However, they fail to offer any clear assessment as to how effective the various programs have been in reducing the U.S. cocaine supply. The author's conclusion is that such programs have reduced the supply somewhat, but are far from capable of eliminating it. The basic problem is that a small reduction in the supply results in higher prices, and these higher prices make the industry even more profitable. The Colombian wholesale price of $2650 per kilogram is only 2% of the 1992 U.S. retail price, about $130,000 per kilogram. This permits an appreciable increase in Andean prices without much impact on the U.S. price, or the U.S. consumption.

This argument suggests limited effectiveness for Andean cocaine control programs. A RAND study estimated that a 1% reduction in U.S. consumption would cost $34 million if obtained through treatment, $246 million if through domestic law-enforcement, $366 million if through anti-smuggling efforts, or $738 million if spent in countries where the drug is produced. However, treatment appears to have limited effectiveness, with most who go through treatment resuming consumption. One long-term follow-up study found that of those who dropped out of treatment, 44% had no consumption six years later, a rate not appreciably different from those who completed treatment.

Finally, while this book is filled with statistics and economic analysis, one should remember that it does discuss an illegal industry, one where statistics are not formally collected. As a result all the numbers are only approximations. Yet it is better to have the approximations this book offers, than no information at all.

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Crime as Destiny
A Study of Criminal Twins

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Translated by Charlotte Haldane

Foreword by J. B. S. Haldane

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This is a reprint of the original 1931 translation by Charlotte Haldane of the pioneer 1928 study conducted by J. Lange of the criminal records of a number of monozygotic and dizygotic twins. It is a work of outstanding interest to all who students of criminology, heredity or twin studies.

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Social Security, Voters, and the U.S. Generation Gap

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This paper calculates the "turning point age" after which a person expects to receive a fair return on remaining payments into the social security system. Until reaching this age, the person would be better off repudiating any entitlement to receive social security, in return for the ability to save each month in a tax preferred account an amount equal to what the social security taxes would have been. The turning point age has risen through time and the size of the majority of eligible voters who are older than the turning point age, and therefore prefer the status quo, has dwindled. Interest in reforming the social security system has strengthened because of the recent increase in the percentage of voters who would gain from outright privatization.

Key Words: Social Security, Voters, Generation Gap, Privatization, Turning Point Age.

I. Introduction

Consider a type of "cold turkey" privatization of the social security system in which one could forfeit any entitlement to receive future benefits in return for the right to keep in a personal, tax preferred retirement account all future payments made by the person and the person's employer. Upon reaching normal retirement age, the person would use the retirement account to purchase a life annuity that would pay a monthly taxable income to the retiree. It is obvious that those in retirement or very close to retirement would not be able to save up very much, would not be able to buy a large annuity, and would prefer to

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receive the social security benefits that the status quo promises. At the other end of the age spectrum, young workers would foresee a future long enough to save an amount that would allow purchase of a life annuity that would pay more than social security promises. Such a person would prefer the privatized system in which he saves for his own retirement. Looking purely at self-interest, there is a point between youth and old age at which the person's allegiance switches from being a supporter of privatization to being a supporter of the status quo. This paper calculates this point, called the "turning point age" for various years and for several sets of assumptions, and discusses the implications for voting majorities of this age-based antagonism.

It has been known for a long time that the current recipients of social security's old age pensions are getting a good rate of return on their tax payments into the system. It is also well known that those born in the post World War II years will not get a fair rate of return on their payments.[2] The process leading to this inequity is also well-understood. It has to do with the combination of low population growth rates after the baby-boom of the 1950's and longer lifespans of the retired. This combination leads to the necessity of delaying the onset of receipt of social security, taxing benefits, and/or raising taxes on those still working. Thus, current and future workers will not get as good a deal as current recipients; in fact, the rate of return may even be negative.[3]

Not only have these facts been known for a long time, they were predictable and foreseeable practically from the onset of the social security system.[4] Essentially, the system is a type of pyramid scheme in

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Campbell's (1969) calculations predicted the bad deal that 22-year-olds in 1968 will get when they retire in 2011.

There are several fine recent sources discussing the social security problem. See Gokhale (1998), Kotlikoff (1998), and Bohn (1998). Eisner (1998) expresses the minority view that there is no problem . . . as long as productivity continues to grow exponentially.

Early critics of the social security system and proponents of reform were numerous but not persuasive. See, for example, Campbell (1969) and Buchanan (1968). Even a supporter of social insurance, Larson (1959), recognized the problem of a pay-as-you-go system. Indeed, Cowan (1977, p. 4) quotes from FDR's Labor Secretary Frances Perkins' (1946) book, *The Roosevelt I Knew*, that even as early as 1935 "the planners foresaw that 'perhaps

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which money is transferred up the pyramid from a larger group to a smaller group.[5] All can gain as long as there is a still larger, or more productive, group beneath them in the pyramid. As in all pyramid schemes, the system becomes insolvent when the groups at the bottom are of insufficient size to keep the transfers flowing. At this point, some combination of cuts in benefits and increases in taxes is required to restore solvency.

However, even if the social security system is inherently flawed, and even if most people through time, including unborn cohorts, are made worse off because of it, it can still enjoy majority support among current voters. This is because current voters are voting themselves benefits and imposing the costs on nonvoters. In a pyramid scheme, this is tantamount to letting only those at or near the top of the pyramid vote.

The papers cited in footnote 2 argue whether and how social security should be reformed. These papers use forecasts of future growth and accounting techniques including generational accounting[6] to try to convince the reader that reform is necessary and that delaying makes it costlier to reform in the future. The contribution of this paper is somewhat different. This paper seeks to determine who the gainers and losers are from the maintenance of the status quo. If, among voters, the gainers from the status quo outnumber the losers, then political support for reform will be weak. Even members of a cohort that the generational accounts say get an overall bad deal from social security will at some point become older than the turning point age, after which they have a vested interest in maintaining the status quo. By tracking the percentage of voters on each side of the turning point age, the support for reform or maintenance of the status quo is easily determined.

The next section presents the basic calculations that are required to

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in 1980 it would be necessary for the Congress to appropriate money to make up a deficit.'"

Kotlikoff (1996) calls it a "chain-letter" method of finance. Donlon (1994) calls it a "Ponzi scheme."

See Kotlikoff (1992).

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determine the turning point age and the voter percentages. Section III looks at the turning point age through time, and analyzes the current turning point age under a variety of assumptions. Section IV is a brief discussion and summary.

II. Basic Calculations

The calculations have three steps. The first step is to calculate the "required nestegg" that one needs at retirement age to mimic the monthly income one expects from social security. The second step is to calculate how many months of saving an amount equal to the combined em ployer/employee social security tax (OASI only) it would take to build up the nestegg, and to subtract that number of months from the retirement age to obtain the "turning point" age. The third step is to calculate the percentage of the voting and nonvoting public that falls on each side of the turning point age.

Step 1: The Nestegg

There are two parts to this calculation. The first is institutional, namely to calculate the monthly social security benefit and to adjust it for taxes. The second is to discover the relationship between a lump sum amount and the monthly payment that it will support, and how the relationship is changed by interest rates and differing life expectancy. Following is a line by line explanation of the derivation of Table 1. Details are in the appendix.

1. For this case the year is 1998; or in cases where data are not available for 1998, information is taken for the latest year available.
2. This is the maximum annual wage allowed for social security taxes for 1997 from *Social Security Manual, 1997 Edition.*
3. This is the maximum monthly wage for social security taxes.
4. The monthly retirement benefit depends on the retiree's Average Indexed Monthly Earnings (AIME), which is essentially an average of yearly earnings on which social security taxes were paid, adjusted for wage inflation and excluding the five years with the lowest inflation-

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TABLE I

1.	year	199a (or latest available)
2.	maximum wage allOWed for tax	$65,400
3.	maximum monthly wage	$ 5,450
4.	monthly social security payment before tax	$ 1,547.37
5.	monthly social security payment after tax	$ 1,292.05
6.	monthly taxable income that yields amount in 5	$ 1,928.43
7.	future life expectancy upon reaching retirement age	16.7 years
8.	required nestegg	288,747.64
9.	social security tax rate	10.7%
10,	monthly income on which (9) applies	5,450
11.	monthly savings	583.15
12.	number of months to save neseagg	249 months
13.	turning point age	45 years 3 months
14.	population younger than 18	69,048,000
15.	population between IS and 45*3	109,587,500
16.	population older than 45:3	86,648,500

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Table 2

Maximum earnings: Various Years

year	latest	1990
Annual wage ($)	65,400	51,300
monthly wage ($)	5,450	4,275
Monthly social security benefit before tax ($)	1,547.37	1,212.38
monthly social security benefit after tax ($)	1,292.05	1,212.38
monthly taxable income that yields above amount ($)	1,928.43	1,818.57
life expectancy at retirement age (years)	16.7	17.2
required nestegg ($)	288,747.64	277,450.39
OASI rate	.107	.112
monthly tax ($)	583.15	478.80
number of months to save nestegg	249	272
turning point age (years:months)	45:3	42:4
population younger than voting age	69,048,000	63,924,000
population between voting age and turning point age	109,586,500	98,314,000
population older than turning point age	86,649,500	86,472,000

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1980	1970	1960	1950
25,900	7,800	4,800	3,000
2,158	650	400	250
635.29	250.72	126.80	76
635.29	250.72	126.80	76
952.93	374.21	189.25	113.43
16.4	14.95	14.3	14.1
141,111.29	52,557.58	25,965.79	15,453.16
.0904	.073	.055	.03
195.08	47.45	22	7.5
306	375	386	485
39:6	33:9	32:10	24:7
63,754,000	80,296,600	70,198,000	54,004,000
79,654,500	36,313,815	27,482,099	10,280,880
83,137,500	86,624,550	81,642,910	87,041,120

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Table 3

One-half maximum earnings: Various Years

year	latest	1990
Annual wage ($)	32,700	25,650
monthly wage ($)	2,725	2,137
Monthly social security benefit before tax ($)	1,135.90	890.32
monthly social security benefit after tax ($)	948.48	890.32
monthly taxable income that yields above amount ($)	1,415.64	1,328.84
life expectancy at retirement age (years)	16.7	17.2
required nestegg ($)	213,026.77	202,734.02
OASI rate	.107	.112
monthly tax ($)	291.57	239.40
number of months to save nestegg	307	331
turning point age (years:months)	40:5	37:5
population younger than voting age	69,048,000	63,924,000
population between voting age and turning point age	89,661,166	79,695,233
population older than turning point age	106,574,834	105,090,767

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1980	1970	1960	1950
12,950	3,900	2,400	1,500
1,079	325	200	125
457.80	154	84	57.25
457.80	154	84	57.25
683.28	229.85	125.37	85.45
16.4	14.95	14.3	14.1
101,181.11	32,282.30	17,201.22	11,641.64
.0904	.073	.055	.03
97.54	23.72	11	3.75
364	411	435	561
34:8	30:9	28:9	18:3
63,754,000	80,296,600	70,198,000	54,004,000
65,933,266	28,307,950	20,446,550	0
96,858,734	94,630,450	88,678,450	97,322,000

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Table 4

One-half maximum earnings: Latest Year by gender and race

category	all	male	female	nonwhite	white
Annual wage ($)	32,700	32,700	32,700	32,700	32,700
monthly wage ($)	2,725	2,725	2,725	2,725	2,725
Monthly social security benefit before tax ($)	1,135.90	1,135.90	1,135.90	1,135.90	1,135.90
monthly social security benefit after tax ($)	948.48	948.48	948.48	948.48	948.48
monthly taxable income that yields above amount ($)	1,415.64	1,415.64	1,145.64	1,145.64	1,145.64
life expectancy at retirement age (years)	16.7	14.8	18.1	15.0	16.9
required nestegg ($)	213,026.77	197,745.29	223,593.88	199,186.72	213,552.56
OASI rate	.107	.107	.107	.107	.107
monthly tax ($)	291.57	291.57	291.57	291.57	291.57
number of months to save nestegg	307	296	315	297	308
turning point age (years:months)	40:5	41:4	39:9	41:3	40:4

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Table 5

Maximum earnings: Latest Year sensitivity to interest rates

category	as above 5.3% annuitization 6% savings growth	6.3% annuitization 6% savings growth	6.3% annuitization 7% savings growth
Annual wage ($)	65,400	65,400	65,400
monthly wage ($)	5,450	5,450	5,450
Monthly social security benefit before tax ($)	1,547.37	1,547.37	1,547.37
monthly social security benefit after tax ($)	1,292.05	1,292.05	1,292.05
monthly taxable income that yields above amount ($)	1,928.43	1,928.43	1,928.43
life expectancy at retirement age (years)	16.7	16.7	16.7
required nestegg ($)	288,747.64	266,041.70	266,041.70
OASI rate	.107	.107	.107
monthly tax ($)	583.15	583.15	583.15
number of months to save nestegg	249	237	222
turning point age (years:months)	45:3	46:3	47:6

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Table 6

Population and Voting

age	population	% voting in 1996	% voting in 1994	# voting in 1996	# voting in 1994
18-45:3	109,586,500	.455	.304	49,810,503	38,310,415
45:4 and older	86,647,500	.653	.578	56,607,817	50,114,067

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adjusted earnings, and then divided by twelve. A different formula applies for each year to convert the AIME into the Primary Insurance Amount (PIA), which will subsequently be adjusted for inflation. For 1997 the formula is 90% of the first $455 of AIME plus 32% of the next $2286 plus 15% of the next $2709 of AIME. This is a progressive schedule that pays lower wage earners a PIA that is a larger percentage of labor earnings.

To make the calculations for this paper, it is assumed that the earner's income profile is flat. Two cases will be considered, a single person earning at least the maximum amount that is subject to social security taxes, and a more moderate income earner assumed to earn exactly one half of the maximum wages that are subject to social security taxes. Therefore, the AIME is essentially the maximum or one-half the maximum monthly wages subject to social security taxes in the year from which the projection is made. Perhaps it is easiest to think of these calculations as based on projections with zero inflation. Since future (and past) amounts are all inflation indexed anyway, one could also think of the future expectations as based on a real income constant assumption. Therefore below, when compounding savings, the calculations use real rather than nominal rates of return.

5. The pace of minor changes in the administration of social security is fast. A changing portion of benefits may be taxable, and some benefits may be subject to a means test. For the calculations for the current year, it is assumed that 50% of benefits are income tax free, and the rest taxed at a an assumed combined federal and state rate of 33%. In previous years, the benefits were all tax free.

6. A private annuity that is purchased with pretax dollars will be subject to income tax. Again, using an assumed combined federal and state income tax rate of 33%, the table lists the taxable income that yields the amount in 5 after tax.

7. Future life expectancy upon reaching retirement is the most important factor in calculating an annuity. The latest table in the *Statistical Abstract of the United States* is for year 1994. The figure in the Table 1 is found by interpolation in the table in the *Statistical Abstract*. The relevant retirement age for this case is 66 years because the turning point age as of today is such that eligibility will come in

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approximately the year 2018 or 2019 when the retirement age will be 66. See the appendix.

8. Knowing the life expectancy, it is possible to calculate the lump sum that would be necessary to buy an annuity that would yield the desired monthly income. Using sample figures supplied by a financial services company (Equitable) as a basis, the required nestegg is derived. Besides life expectancy, the other important parameter of the annuity calculation is the interest rate. Currently, Equitable is using a rate of 5.3% and this figure is used in the calculations. The effect of a one percentage point change in this rate is considered in Section III. See the appendix.

Step 2: The turning point age

The number of years:months it takes to build up the nestegg if one saves each month an amount equal to the sum of the employee's and the employer's contribution to the social security fund can be calculated analytically. The savings are with pre-tax dollars (full taxes are paid on the annuity) and accumulate tax free at the yearly rate of interest of 6% compounded monthly. The conservative estimate of a 6% rate of return compared to a long run average and rule of thumb nominal rate of 10% (or 8% to 12%, see Hieger and Shipman (1997)) is justified because of the no inflation assumption. If inflation were factored in, a 10% rate of return would be more appropriate.

The length of time it takes to save the required nestegg is then subtracted from the retirement age to yield the turning point age. People younger than this turning point would be better off renouncing all claims to receive social security or to receive any of their previous payments back, and from then on to save for their own retirement and purchase a life annuity at retirement age. People older than this turning point will, from that point on, get a better return by remaining in the status quo system. Again, consider the entries in Table 1.

9. The current social security tax rate (OASI only) on the employee is 5.35%, which is matched by the employer for a total of 10.7%.

10. For this example, social security taxes are paid on the total amount of income subject to the tax.

11. The rate of 10.7% applied to the maximum monthly income

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subject to tax yields the monthly savings.

12. When saving a fixed amount (in this case $583.15) each month and compounding monthly (in this case at .005) a lump sum nestegg (in this case $288,747.64) will be reached in n months where n solves the following:

$583.15(1.005)^n + 583.15(1.005)^{n-1} + \ldots + 583.15 = 288{,}747.64$

The answer is rounded to the nearest month. See the appendix.

13. 249 months is 20 years, 9 months (20:9). If it is currently 1998, 20 years and 9 months from now it will be at least 2018 when the normal retirement age will be 66. Subtracting 20:9 from 66:0 yields a turning point age of 45:3 or 45 years, 3 months.

Step 3: Voting majorities

The last step is simply to find the proportions of the population on each side of the turning point age. There are actually three groups: nonvoters (currently those under 18); young (18 to the turning point) and old (past the turning point).

14-16. The population tables are from *The Statistical Abstract of the United States*, and the latest year is 1996. One quarter of those in the age 45 group are counted with the young.

III. Examples

III.A. Social security through time: High income.

The main theme of this research is to track what happened to the turning point age through time. Table 2 lists the results of the calculations at ten-year intervals. The message is clear. The turning point age has steadily increased throughout this time period. As of 1950, those older than 24 years, 7 months would expect a good return on their future tax payments and would prefer the status quo. Only the relatively few worker/voters younger than 24 years, 7 months would gain from outright privatization. The population was such that the social security system would have been favored by almost a 9-to-1 margin. Through time the size of the voting majority steadily dwindles and the turning point age increases. By 1990 a switch occurs; the majority of eligible voters would gain from privatization.

There are several factors systematically at work through time. First

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of all, life expectancy at retirement has increased steadily until the most recent years when the future expected retirement age itself is increased. This effect would actually work toward a younger turning point age because with a longer life expectancy, the nestegg needs to be larger. Evidently, however, this effect is swamped by other factors working in the opposite direction.

The factors working to increase the turning point age involve the rates of increase in promised benefits and the rates of increase in tax payments. From 1950 to 1998 the tax rate has gone up threefold. Perhaps more important, the amount of income that is subject to the OASI tax has gone up by a factor of 21.8. The combined effect of increased tax rates and increased tax base is that the monthly tax has gone from $7.50 to $583.15 or by a whopping factor of 77.8. Of course, part of this is inflation, but over the same period the after tax monthly benefit has only increased by a factor of 17.

Interestingly, the number of voters older than the turning point age has remained relatively constant between 81 and 87 million people. The number of voters below the turning point age has steadily increased, with the largest jump coming between 1970 and 1980 as a result of two things, the lowering of the voting age to 18 and the enfranchisement of the baby boom generation.

III.B. Social security through time: Moderate income.

The above calculations for the high income case are on the pessimistic side for support of social security because social security benefit payout formulas are progressive in nature. Table 3 lists the calculations for the assumption that the income stream is equal to one half of the maximum amount of wages subject to social security taxation. The turning point age in these calculations still rises through time, but is lower than the corresponding age calculated above. Nevertheless, the current turning point age is still in the forties.

Interestingly, in 1950 the turning point age was not dramatically different from the voting age so that virtually every voter stood to gain from maintenance of the status quo. By 1960, however, the tax rate had almost doubled, the tax base had increased by more than 50%, and the monthly tax payment per worker had nearly tripled. During the same ten

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years the promised benefits had increased by less than 50%. The turning point age actually jumped by more than 10 years during this decade. Some hapless people born in 1932 would have been above the turning point age in 1950, expecting a fair deal from social security, and below the turning point age ten years later. As evidenced by the most recent figures, there is still a voting majority in favor of the status quo, but the size of the majority has narrowed dramatically from the unanimity social security enjoyed in 1950.

III.C. Gender and Race

Depending on life expectancy at retirement, different people get different value from the social security system. Generally speaking, women live longer than men and whites live longer than nonwhites, meaning women and whites get the better deals. Therefore, the turning point age is lower for women than it is for men, and lower for whites than it is for nonwhites. Table 4 lists these results for the moderate income case for the most recent year.

Table 4 indicates that the turning point age changes as a function of future life expectancy upon retirement, but the effect is inelastic. Comparing males to females, the 22.3% longer life expectancy of females (from 14.8 years to 18.1 years) leads to only a 6.4% increase in the number of months it takes to save the required nestegg (from 296 months to 315 months) and only a 3.8% decrease in the turning point age (from 41 years, 4 months to 39 years, 9 months).

III.D. Interest rate sensitivity.

The results are also changed, but inelastically so, by different interest rate assumptions. Table 5 lists the results for three calculations. All three columns use the high income case for the most recent year's calculation. The first column is a repeat of Table 1 in which the interest rate credited during the annuitization is 5.3% and the interest rate for savings compounding is 6%.

If the interest rate credited for annuitization were to increase by one percentage point (an increase of almost 19%), a smaller nestegg would be required and the turning point age increases by one year (an increase of only 2.2%). If additionally, the interest rate for compounding savings

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were to increase by one percentage point (an increase of 16.7%), then savings would accumulate more rapidly and the turning point age would be increased by another year and three months (an increase of only 2.7%).

III.E. Voter apathy.

The potential voting majority in favor of the status quo has greatly diminished, if not disappeared altogether. However, if young people do not vote with the same frequency as old people, the fact that a majority of the population may favor privatization of social security will not be registered at the polls. Table 6 shows the percentage of eligible voters on each side of the turning point age who voted in 1994 and 1996. Even though there may be more young than old eligible voters, the higher turnout among the old voters allows those favoring the status quo to maintain their majority among actual voters.

IV. Discussion and Summary

The calculations in this paper give us ballpark estimates of the turning point age, beyond which a person receives a fair rate of return on his tax payments into the social security system. As shown in this paper, the age is affected by interest rates, life expectancy, average income, income and social security tax rates, means testing of benefits, social security benefit formulas, and the amount of wages subject to social security taxes. Although not explicitly calculated in this paper, the age is also affected by marital status, spousal income, spousal life expectancy, expected inflation, wage and productivity growth, and a host of other factors. For each person and under each set of circumstances, the turning point age is different, and it is neither possible nor desirable to list all of the permutations. The calculations presented in this paper give the general picture of what has happened to the underlying demographic support for the social security system through time.

Two of the simplifications employed in the above calculations deserve special attention. First, by assuming no inflation, an advantage of social security, namely its adjustment for inflation, is not given its due. Since the life annuity payments are calculated for no inflation, the PIA of social security, adjusted for the inflation that does occur, might represent

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a better deal. Of course, the PIA was not always adjusted for inflation, and any adjustment that does occur is simply a legislative act which could be eliminated or reduced by future lawmakers. Indeed, curtailing the inflation adjustment is often mentioned as a method of "saving" social security.

The second simplification works in the opposite direction. A benefit of the private system over social security is that a person's estate will receive the nestegg of the hapless person who dies just before retirement age, while the estate of the social security recipient may only receive a modest death benefit.

Rather than presenting an exhaustive listing of all the possibilities, this paper has chosen a few of the factors in order to illustrate what has happened to the turning point age over time. The results are conclusive. The turning point age has steadily increased from the late teens or early twenties in 1950 to the late thirties or early forties in 1998. This steady pushing back of the turning point age means that more and more people are on the younger side and would gain from dropping out of the system or from the system's privatization.

One thing that the calculations make clear is that social security reform is a young person's issue. It is the young people, and all future generations, who are harmed by the system. People older than the turning point age have a vested interest in maintaining the system, even if it means higher taxes on the young and future generations. Of course, those under the franchise age and those yet unborn have no direct say in the matter. They must rely on the young voters to force meaningful reform of the system. If young voters do not turn up at the polls to register their preferences on behalf of themselves and those too young to vote, then those older than the turning point age can be expected to influence policy for their own benefit. This means that reform efforts will concentrate on short-term fixes so that the system will not run out of funds while those currently over the turning point age are still alive. After that, the system may or may not be completely funded, depending on how fast the economy has grown in the interim. The young are left to hope that the rosier projections of growth are realized.

Another implication of the calculations in this paper is that they provide a new perspective on what some politicians might mean when

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they claim to want to save social security. One could ask, "For whom do we want to save social security?" Many might think that the answer is to save it for the young, and for future generations. But this is clearly the wrong answer. The young and future generations would be better off if the system were dismantled in favor of a system of private retirement accounts. If for anybody, we are saving social security for the old, for those collecting or near to collecting the benefits by virtue of being at the top of the pyramid scheme. The old are the ones who have paid into the system over the years to pay for those above them in the pyramid, and it is now their turn to collect. The old are the biggest potential losers from a near-term collapse in the system. Many older people feel that they were duped into believing that the system was an actuarially fair and fully funded pension system. Nevertheless, it is today's older generation that either voted for or acquiesced in the way the system currently runs.

And, in conclusion, we should mention that when attention is paid to the generation gap, a political catch-22 type problem arises. In order to actuarially secure the future of the system, reforms such as raising tax rates, taxing benefits, means testing of benefits, delaying the retirement age, or reducing the inflation adjustment may be called upon. Unfortunately, each of these reforms, while securing the long- term finances of the system, push the turning point age to higher levels, thus eroding the system's political support and creating a critical political mass in favor of outright privatization.

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APPENDIX

Life expectancy. To find the life expectancy in line 7 of Table 1, the Statistical abstract lists the life expectancies for age 65 and age 70 listed below.

AGE	LIFE EXPECTANCY	
65	17.4	therefore x solves:
66	x	(66-65)/(70-65) = (x-17.4)/(14.1-17.4)
70	14.1	x = 16.74 which rounds to 16.7

Nestegg. The Equitable supplied figures on how much one could receive per month until death if an account had $100,000 in it for four cases, male and female for ages 65 and 66. The calculations were based on an interest rate of 5.3% and yielded the following monthly payments.

age and gender	monthly payment	life expectancy
male age 66	713.30	14.9

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male age 65	695.15	15.6
female age 66	625.67	18.4
female age 65	611.30	19.1

Males and older people get more per month because they are expected to die sooner. The relationship is not a linear one so instead of using linear interpolation, experimentation yielded a consistent relationship between the percentage increase in life expectancy and the dollar decrease in the monthly payment. On average, between life expectancies of 14.9 and 15.6. each one percent increase in longevity caused a decrease of $3.86 in the monthly payment. On average between life expectancies of 15.6 and 18.4, each one percent increase in longevity caused a decrease of $3.87 in the monthly payment. Finally, on average between life expectancies of 18.4 and 19.1, each one percent increase in longevity caused a decrease of $3.78 in the monthly payment. These relationships are used in the calculations of the required nestegg.

So, for a life expectancy of 16.7 years, that corresponds to a percentage increase over 15.6 of 7.05128%.

$$.0705128 = (16.7 - 15.6)/15.6$$

Since each percentage point costs $3.87 in this range, the monthly payment is reduced by $27.29.

$$-27.29 = 7.05128(-3.87)$$

So the monthly payment is reduced to 695.15 - 27.29 = 667.86.

This monthly payment comes from a lump sum of $100,000 so we set up the following proportions to solve for the required nestegg:

$$100{,}000/667.86 = x/1928.43$$
$$x = (1928.43/667.86)100{,}000$$
$$x = 288747.64$$

Number of months to save nestegg. To solve the equation in the text for n the following procedure is used. Let n be given by the solution to:

$$583.15(1.005)^n + 583.15(1.005)^{n-1} + \ldots + 583.15 = 288{,}747.64$$

Multiply each side by 1.005 and subtract the first equation from the second. Writing it out:

$$583.15(1.005)^{n+1} + 583.15(1.005)^n + \ldots + 583.15(1.005) = 288{,}747.64(1.005)$$

After subtracting the top from the bottom:

$$583.15(1.005)^{n+1} - 583.15 = 288{,}747.64(.005)$$
$$583.15(1.005)^{n+1} = 1443.74 + 583.15$$
$$(1.005)^{n+1} = 2026.89/583.15$$
$$(1.005)^{n+1} = 3.4757578$$

Now, take the natural logarithm of each side:

$$(n+1)\ln 1.005 = \ln 3.4757578$$
$$n = (\ln 3.4757578/\ln 1.005) - 1$$
$$n = 249.78 - 1$$
$$n = 249 \text{ months (approximately)}$$

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An Artistic Renaissance?

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The author observes that in recent decades, the arts and humanities have been dominated by forms known as "modernism" and "postmodernism," which have repudiated traditional artistic and literary forms. However, he notes signs of an artistic renaissance, and in particular examines the evidence presented in one journal, *The American Arts Quarterly*.

Key Words: The arts, humanities, *American Arts Quarterly*, aesthetics, beauty, artistic renaissance, modernism, postmodernism, blacklisting, James F. Cooper, Frederick Turner, purposes of art.

Since the 1920s, the arts and humanities have been dominated, within the various levels of the "arts establishment" in Europe, the United States and elsewhere, by "modernism" and "postmodernism," which have repudiated traditional artistic and literary forms. Outside the establishment, and despite its various gatekeepers, much excellent work has been done by artists who are oblivious to the demands of the cognoscenti. Recently, however, even the establishment itself as an intellectual bastion has come to be challenged in all fields by a "new renaissance." An example of this renaissance is the *American Arts Quarterly*, published for the past 16 years by the Newington-Cropsey Foundation. This article will include an examination of that journal's philosophy, the meaning of this intellectual revolution, and several of the wider social and cultural issues suggested by the "culture war's" conflict over aesthetics. It is impossible to understand the nineteenth and twentieth centuries without grasping the central role played by the "alienation of the intellectual" against the predominant "bourgeois" culture. Contempt for the mainstream society in the West has set the stage for much that has occurred in virtually all aspects of the intellectual, political, ideological and cultural history of the past two centuries.

It is beyond the scope of this article to discuss these many ramifications, even though they are relevant to the artistic and cultural issues we will discuss. What is most directly to the point is that during the eighty years since the end of the First World War the official artistic

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and literary "establishment" throughout Western civilization has been committed to a repudiation of the elements of aesthetics and literature that have characterized the West since the Greeks. For eighty-plus years, the "cognoscenti" in those fields have been committed first to "modernism" and then to "postmodernism."

A source of frustration for the alienated intellectual elite, not just in matters of culture but of politics and ideology as well, has been that the gigantic mainstream society, though in many ways headless since it has lacked the leadership and inspiration that an appropriate artistic and literary subculture ideally must give a free society, has gone on about the business of life. Outside the domains controlled by the cognoscenti, millions of people have continued to paint, to carve, to write, to compose, utterly oblivious to the fact that the art establishment looks upon their work with disdain. This doesn't mean that in many ways those millions aren't affected by the establishment's worldview; but the influence is less than is often imagined: life goes on. Taking just Western (United States) Art as an example, such as one finds it in the journal *Art of the West*, many fine painters in Santa Fe, Tucson, Jackson Hole, Albuquerque, Wichita, and the like, have throughout the twentieth century produced excellent work. Wilson Hurley, for one, stands among the great masters of all time, with his magnificent skyscapes. But most such work has gone unremarked within the domain of what we might call "intellectualized art." Representational painting, melodious music, humanistic sculpture – all have gone on, even though they aren't the works that win the awards and governmental commissions or receive the scribblers' acclaim.

Our emphasis here will be on art at the "higher," more self-consciously intellectual, levels, although always with the caveat that the great corpus of human artistic endeavor deserves much more credit than this emphasis will give it. A point to note is that even at this more rarefied level there have always been many individuals who have stood out against the conformist pressures of an establishment.

What we see in recent years, however, is that such people have started to become organized, to become conscious of the conflict between their values and those of the official cognoscenti, so that a self-conscious movement toward a "new renaissance" has come into being. What is occurring is not a banal imitation of aesthetic forms from the past, but an eagerness to apply those forms to the world as it is and will be.

Perhaps most illustrative of this "new renaissance" is the *American*

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Arts Quarterly. On one dimension, the *AAQ* can be appreciated for its beautiful reproductions and informative essays about artists, schools of art, galleries, exhibitions, collections and books. It goes beyond that, however, with an on-going discussion of the philosophy of art and of culture. This makes it one of the more thoughtful and intellectually provocative journals published in the United States. This is especially so because the *AAQ* reaches back to the past and forward to the future with genuine originality; it is the mouthpiece for no orthodoxy.

The "new renaissance" has other voices, too, since movements are springing up in all contexts. The *AAQ* refers to "the new California figurative realists,...the poets of the expansive poetry movement, the New Formalists and Narrativists, the new tonalists and modalists in music."[1] James F. Cooper, the editor and publisher, speaks of "the Communitarian Movement, Romantic Realism in the arts, the New Classicism in architecture, the New Narrative in poetry."[2] • In 1997 a professor at the New School for Social Research, classical composer Stefania de Kenessey, established the "Derriere Guard," which holds an annual festival, for the purpose of fusing past and present, Western and Eastern, tradition and innovation. She is said to see this as a "third side in the American culture wars," adopting neither "right-wing classicism" nor "left-wing avant-gardism."[3]

• In 1998 the society "Classical America" marked its thirtieth anniversary; it was founded "to promote the classical tradition in architecture, painting and sculpture."[4]

• The AAQ reports a religious renaissance also is underway and finding expression in the arts.[5]

• A non-profit foundation that exalts the rational and heroic, is called ART ("American Renaissance for the Twenty-First Century"). It is "dedicated to a rebirth of beauty and life-affirming values in all of the fine arts." More specifically, this is through "representationalism in

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[1] Frederick Turner in the Winter 1998 issue, p. 32.

[2] James F. Cooper in the Summer/Fall 1994 issue, p. 3. By way of explanation, the Communitarian Movement is said by James Howard Kunstler to embody "momentum all over America to create communities that are worthy of our affection...Some people know it as the communitarian movement. To architects and planners, it goes under the name of the New Urbanism." Kunstler in Summer/Fall 1994 issue, p. 22.

[3] Spring/Summer 1998 issue, p. 8.

[4] Summer 1997 issue, p. 44.

[5] Summer 1995 issue, p. 23.

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painting and sculpture; melody and harmony in music; grace in dance; structure, coherence and meaning in drama, poetry and literature – and the expression of beauty in all."[6] ART's quarterly, *Art Ideas*, began publication with its Spring 1994 issue.

• The American Society of Classical Realism, located in Minneapolis, publishes the *Classical Realism Journal*, which its masthead says is "dedicated to a renewal in the visual arts."[7]

• In 1992 Hillsdale College in Michigan opened its 47,000 square feet Sage Center for the Arts, about which it is said "we offer our students traditional art courses in the classical and realist mode, with an emphasis on life drawing, drawing from the cast, mastery of line, light and shade, proportion."[8]

No doubt there are others, and an injustice is committed by mentioning just certain ones.

After listing a number of these movements, Frederick Turner (who will be discussed for his own sake later) said that their effect on the existing establishment is that "they are trashing everything held dear by the high priests of both modernism and postmodernism."[9] They stand in an adversarial relation to the twentieth century literary and artistic orthodoxy.

"Modernism"

Although the writers for *AAQ* are by no means opposed to all abstract painting, praising, for example, "the beautiful abstract works by Kandinsky and Paul Klee,"[10] they are critical of abstractionism's having "purposefully removed the work of art from any connections to the external world, to nature, to history, to human life,"[11] concomitantly consigning representational art to disrepute.

Modernism came upon the scene as early as 1860, although it didn't become the orthodoxy until the 1920s, and held sway during the twentieth

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[6] For further information about ART, contact it at F.D.R. Station, P.O. Box 8379, New York, New York 10150-1919.

[7] See the advertisement in the Winter 1998 issue of the *AAQ*, p. 47.

[8] See the interview with Sam Knecht, director of the Hillsdale College art department, in the Summer 1992 issue, pp. 22-24.

[9] Turner in the Winter 1998 issue, p. 32.

[10] James F. Cooper in the Summer 1997 issue, p. 7.

[11] Gene Edward Veath, Jr., in the Winter 1995 issue, p. 27.

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century until approximately 1960.[12] Painter James McElhinney says "modernism gave us form in the absence of content."[13] For the artists of the "new renaissance," modernism's significance is most to be found in its negative aspect: the forsaking of traditional aesthetic values and criteria. Thomas Gordon Smith writes that "we are emerging from an eighty-year period that has been characterized by the denigration of the value of traditional form and connotation in all facets of our lives, including architecture. The men who invented modernism in the 1920s rejected traditional forms as stuffy, bourgeois, and politically incorrect... It has become the rigid orthodoxy of the artistic establishment."[14]

"Postmodernism"

Postmodernism has prevailed within the intellectual elite since the 1960s, reflecting the counterculture that reached its peak in that decade and the 1970s and that has left major residuals that are very much a part of American culture to this day. The writers of the *AAQ* tend to relate it most directly to the writings of the "poststructuralist" philosophers Jacques Derrida and Michel Foucault, who introduced a "radical relativism" that was useful "largely because it can be used to attack and 'deconstruct' the status quo." The literary canon and traditional criteria are seen by the postmodernists as establishment devices of white males.

It isn't an error to focus on Derrida, Foucault and deconstructionism, since their influence has been vastly important within the postmodernist elite. It is surprising, however, to find little recognition within the pages of *AAQ* of a longer-term perspective – *i.e.*, awareness of the fact that the members of the alienated intellectual subculture have in effect been "standing outside the main culture," picking apart everything about it, since as long ago as Rousseau in the early eighteenth century. What we are seeing is the accretion of 250 years of intellectual-literary-artistic alienation. Indeed, everything we see as part of the ideologized, nihilistic postmodernist movement, which is today's orthodoxy, reached a peak in the Dadaist movement immediately after World War I. There, art became a weapon against art itself and against Western civilization as a whole. An interesting thing about Dadaism is that it adopted the style of

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[12] James F. Cooper in the Winter 1995 issue, p. 3.
[13] Interview with McElhinney in the Spring 1996 issue, p. 12.
[14] Thomas Gordon Smith in the Summer 1997 issue, p. 8.

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playfulness, farce and ridicule that later became so potent a weapon in the hands of Abbie Hoffman and Jerry Rubin in the New Left. That same spirit pervades postmodernism. In his book *Dada*, Kenneth Coutts-Smith said that "the most obvious aspect of Dada... was a savage anarchism, a deliberate programme designed to undermine the moral and social assumptions of existing middle class society." Among many examples, he cited a 1920 art exhibit in which patrons entered through a public lavatory and were then confronted "by a young girl dressed as for her first communion who suddenly began to recite obscene verses."[15]

Postmodernism, Gene Edward Veath, Jr., says, differs from modernism in that it returns art to a representation of the world. It "attempts to restore art to its external references... Representational art is back, but it tends to be critical rather than celebratory, stressing bleak and shocking images rather than the beauty of nature or intimations of divine order... Their art will tend to be political rather than moral or philosophical... One artist displays his bowel movements. Instead of making art that is beautiful and pleasing, some artists experiment with art that is purposefully ugly and infuriating."[16] One work in a New York exhibit consists of "human feces on white cube."[17] The rules for postmodernism, Turner says, have been "Was it shocking? Did it break the conventions of representation? Was it difficult to recognize or understand? Was it rather ugly and unpleasant to look at?... If so, then it was good."[18]

Turner's explanation allows us to understand what I observed on a recent trip to Telluride in southwestern Colorado. Telluride is an old mining town, now made chic, nestled in a bowl formed by majestic mountains that tower for thousands of feet above it with pine and aspen-covered slopes. Just down the road at the end of the box canyon, Bridal Veil Falls cascades for hundreds of feet. Looking far up, one sees as tiny specks the signs of heroic human endeavor a century ago in the mine tailings from diggings on steep slopes far above timberline. No place was ever better formed to inspire exalted art. On Main Street, there is a small sign saying "Art School," with an arrow pointing down a side street. I

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[15] Kenneth Coutts-Smith, *Dada* (New York: E. P. Dutton and Co., Inc., 1970), pp. 22, 116-117.
[16] Gene Edward Veath, Jr., in the Winter 1995 issue, p. 27.
[17] Referred to by Frederick Turner in Summer 1995 issue, p. 22.
[18] Turner in the Summer/Fall 1994 issue, p. 25.

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walked the short block to the school with excitement, only to find a courtyard filled with the most grotesque statuary. The students and teachers at that school were choosing not to make the surrounding beauty their subject. Even in that setting, conformity to the *de rigueur* alienation of the twentieth century artistic and literary elite held firm. My main reaction was boredom, and I didn't bother to go inside.

Contrast: An Affirmation of Life

The writers for the *AAQ*, most of whom are artists themselves, are essentially open to all forms of expressiveness. We have seen that there is no automatic rejection of abstractionism (an American abstractionist the editor especially likes is Jackson Pollock[19]). They are not even opposed to all expressions of alienation and angst; Andrew Wyeth is praised as "one of America's great modernists," with a "haunting existential vision... pitiless landscapes... sensitivity to the alienation of twentieth-century American life."[20] Stephen May says about Edward Hopper, painter of *Nighthawks* and *Early Sunday Morning*, that he was "the preeminent chronicler of the alienation, isolation and longing of mid-century America by raising to epic timelessness such seemingly prosaic subjects as people in gas stations, restaurants, hotels and apartments."[21] Despite observing that modernism and postmodernism have invoked "atonality in music, abstraction in painting and sculpture, the plotless novel, the meterless and unrhymed poem, the theater of cruelty, and Bauhaus architecture," Frederick Turner is able to say "I am not denying that good art was made in these forms...."[22]

But the *AAQ* much prefers an expressive affirmation of life and nature. As we scan its pages, here are some of the things its writers praise about a wide variety of works: "Primal ferocity, spirituality and beauty"... "mythology, primal imagery"... "energy, light"... "remarkable control"... "serene and tender"... "elegance, grace and technical perfection"... "tender, languid images"... "monumental dignity and rich orchestration of color"... "staunch realism and strong play of light and shade"... "dramatic composition"... "superb narrative skills"...

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[19] See the Winter 1999 issue, pp. 3-7, 36.
[20] James F. Cooper in the Spring/Summer 1998 issue, p. 3.
[21] Stephen May in the Summer 1995 issue, p. 29.
[22] Turner in the Spring/Summer 1998 issue, p. 31.

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"painstaking draftsmanship"... "deft spatial relationships"... "delicacy of contrasts." Far from favoring only what is purely classical, Turner, for example, relishes democratic art as found in jazz, some television, science fiction and Broadway musicals, provided these things contain "quality and enduring relevance."[23]

The attention given to specific artists and works of art is raised in many articles to a more systematic discussion of aesthetics. "What makes great art?" is a common theme. Value is given to the "normal critical criteria," which are seen to reflect the artistic heritage of Western civilization.[24] Contrary to the postmodernist view, "beauty" is highly prized. Since most readers of this article won't have the time to read the back issues of the *AAQ*, it is worthwhile to share some of the insights here:

- To James Reid, "beauty is the splendor of being."[25]
- To Rod Miller, "the classical vision of beauty is connected with the classical vision of reality. Beauty was pursued as the manifestation of truth and goodness. That which was most fully true and good was considered more real, more beautiful, than that which was not... The Greeks sought to construct rational and orderly buildings." Miller speaks of Thomas Jefferson's use of the "three Vitruvian ideals: *utilitas, firmitas*, and *venustas* (utility, strength, and beauty)."[26] This reference to the Vitruvian ideals is explained by Thomas Gordon Smith when he refers to "the Roman architect Vitruvius" and says that "his *Ten Books on Architecture* culls and synthesizes five hundred years of Greek architectural ideas. The classical language of architecture was initiated in Greece 2,500 years ago."[27]
- Stephen Gjertson explains that "of the many treatises on beauty, one of the most lucid and thorough is by American sculptor F. W. Ruckstill. In his book *Great Works of Art and What Makes Them Great*, Ruckstill states that 'Melody is the fundamental *essence* of all beauty... Patterns of lines, tones and colors produce melody. Melody works together with harmony. Harmony is variety in unity with dominance." Gjertson adds

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[23] Turner in the Spring/Summer 1998 issue, p. 32.
[24] Cooper in the Winter 1999 issue, p. 6.
[25] In the Winter 1998 issue, p. 10.
[26] Rod Miller in the Spring 1996 issue, pp. 35-39, 44.
[27] In the Summer 1997 issue, p. 9.

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that "for the artist, there are three additional considerations. First, there is beauty of workmanship, technical proficiency... Second, there is integrity. A work of art must be complete... Third, there is clarity. To be beautiful, what is seen must be comprehended without difficulty or confusion... Finally... is the message or subject of a work of art. Fine conceptions express enduring truths, either about the visible world or the human condition."[28]

• In an article entitled "What Makes Art Great," Burton Silverman speaks of "a painting that aims toward that elusive goal of greatness, one that's illuminated by a passion of some kind." He says "it's the capacity to heighten our sensitivity to experience that gives art its specialness." This involves "the artist's personal, *human* vision... a vision that's selective, that has priorities, and that brings ambiguity and uncertainty into the visual equation."[29]

The Variety of Aesthetic Theory

While the *AAQ* is clearly opposed to art-as-negation and favors Western civilization's traditional criteria, the quarterly's pages give voice to the broad range of philosophical perspectives that exist side-by-side among American opponents of the Left. It has no fixed philosophy as among them.

Often, one reads Burkean conservative insights. Turner reminds us of the Augustinian "doctrine of human depravity" (embraced by Burkeans such as the late Russell Kirk) when he opines, as part of an explanation of laughter, that virtually everything about the human condition is "shameful": "We are ashamed about our sexuality, about how we came into the world, about how we did not at one time exist, either as a species or individually... We are ashamed of our bodies, which display an impure and inextricable mixture... We are ashamed about eating, because whatever we eat, we are assuming... that we must be more valuable than what we destroy with our teeth and digestive juices... We are ashamed about our economic system...."[30] Alexander Argyros expresses a Burkean orientation, such as Richard Weaver's view that things have been going awry since the fourteenth century, when he speaks of "the four-hundred-

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[28] In the Fall 1995 issue, pp. 30-31.
[29] In the Spring 1992 issue, p. 20.
[30] In the Fall 1998 issue, pp. 36-37.

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year schism between science and the humanities."[31] James Cooper takes a similar perspective when he says that "modernity – with its source in the Enlightenment – has eclipsed morality of any sort, except for the Nietzschean moral extremes... The skepticism engendered by the Enlightenment has reduced all ideas of right and wrong to matters of personal taste, emotional preference or cultural choice."[32]

The desire to reiterate a pre-Enlightenment aesthetic canon often leads back to philosophical Realism, the outlook that was upset by the Nominalists in the fourteenth century. This is the view that the things of the world have essences, and that those essences are more real than the fleeting forms that the things may from time to time assume. James Reid, accordingly, says that "form determines the essence or nature of a thing." The marriage of this conception of the world with theology is evident from his further statement that "nothing exists unless God acts within it, as the wellspring of being, at every moment."[33] From this, we can see why the Hudson River School, whose mid-nineteenth century artists infused an unspoiled American landscape with the immanence of God, is often revisited within the *AAQ*.

Nevertheless, there are occasional hints of Ayn Rand's philosophy (in many ways a philosophical opposite in its atheism and anti-mysticism). A comment by Earl Davey closely matches the point made by the Randian hero Howard Roark in his courtroom speech in *The Fountainhead*: "Failure with respect to artistic integrity is, I suggest, a moral issue..., for it constitutes an act of infidelity to self as well as to others."[34] One *AAQ* issue came with a supplement advertising ART (as mentioned before, the non-profit foundation "American Renaissance for the Twenty-first Century"), which strikes this author, from a number of conceptual clues in its brochure, as strongly Randian.

Two Philosophers Central to the *AAQ*: James F. Cooper and Frederick Turner

Many writers participate in the *AAQ*'s numerous issues, but the quarterly is a platform for two in particular: James F. Cooper, the editor

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[31] Quoted by Robin Fox in the Summer 1995 issue, p. 13.
[32] In the Summer/Fall 1994 issue, p. 4.
[33] Both of the quoted statements are in the Winter 1998 issue at pp. 10 and 12, respectively.
[34] In the Winter 1995 issue, p. 11.

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and publisher, and Frederick Turner. Turner, who is Founders Professor of Arts and Humanities at the University of Texas, Dallas, was invited by Cooper in 1993 to work with the magazine, and he serves on the editorial advisory board. Both men are first-rate thinkers who deserve, in their own right, to be well known among educated people today.

James F. Cooper.

It is Cooper, above all, who states the *AAQ*'s themes mentioned above, and who as the editor and publisher must be understood as the driving force behind the quarterly. He is a philosophical Realist when he says "the forms speak to us through archetypes that spring from a universal subconscious"; and reflects Burkean concerns when he quotes Edward F. Edinger to the effect that a society requires "a central living myth," something Cooper observes Western civilization has lacked through much of the twentieth century.[35] He defends the traditional aesthetic criteria against postmodernism's attack, decrying that "art historians now advocate setting aside the criteria that have dominated Western art for the last two millennia." He heralds the "counter-counterculture" that he sees arising: "Can a nation survive with a culture based incessantly upon endemic, chronic collective guilt? Fortunately, the cult of abjection and the deconstruction and post-structuralization of values has given rise to a counter counterculture which embraces beauty, aesthetics, spirituality, myth, and transcendence."[36]

Frederick Turner

When Cooper brought Turner aboard, he introduced an intellectual of high excitement, a virtual whirling dervish of ideas. Turner's is one of the more creative intellects at work in the world today. A consensus within the "new renaissance" is more likely to settle around the more earth-bound foundation laid by Cooper, but Turner interjects a mixture of provocation, cutting-edge scientific insight, futurism, globalism, evolutionary perspective, and poetic flights of fancy that makes him "a work of art" in himself. He writes often for the *AAQ*, but I would especially direct readers to his articles "The New Arcadia: A Vision of

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[35] In the Winter 1995 issue, p. 3.

[36] In the Winter 1995 issue, pp. 4, 6.

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the Future" in the Winter 1995 issue; "Tree and Bridge: Art, Knowledge and Cultural Change" (Spring 1996); and "Beauty and the Beast" (Winter 1998).

There is so much to him that it is hard to know where to begin. Let's start with what would appear to be his genuine cutting-edge knowledge of the new information sciences. Turner shows a deep understanding of the on-rushing technology and its many implications such as its impact on work, easing of stress on the environment, the predictable colonization of Mars, lengthening of the human lifespan, and the prospect of turning of the earth into a garden.[37] At one point, he says that "chaos and complexity theory have given us ways of including the discontinuous, unpredictable and emergent together with the linear, predictable and deterministic...."[38] He says that, although he was originally a modernist who looked down his nose at traditional art, he was led to "a non-relativistic aesthetic through neuroscience and perceptual psychology."[39] He has sought to arrive scientifically at an aesthetic that is not limited to a single culture but is based instead on universals.

Turner places evolution in the context of information theory: "Evolution itself is the archetypal iterative nonlinear dynamical feedback system." He points to how functional it is for human beings to believe in such things as beauty, value, meaning and teleology – and says that those who believe in them have an evolutionary competitive advantage over those who do not.[40] The result is that these successful qualities become written in our genes.[41] But he is opposed to seeing human beings as genetic robots, which he considers reductionist; the evolution he speaks of is more the evolution of cultures than of individuals, acting, as Richard Dawkins has argued, for understanding the evolution through "'memes' – fragments of cultural information that act like genes."[42]

This gives the traditional Western canon, which Turner sees as really a universal canon, a Kantian-like immanence; Kanchan Limaye reports that in a keynote address to the 1998 Derriere Guard Festival, Turner "discussed the natural classicism and the "new renaissance," arguing that

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[37] See especially his discussion in the Winter 1995 issue, p. 30.
[38] In the Spring 1996 issue, p. 16.
[39] In the Summer/Fall 1994 issue, p. 24.
[40] In the Winter 1998 issue, p. 35.
[41] See page 17 of the Spring 1996 issue.
[42] In the Winter 1998 issue, p. 33.

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a sense of beauty is not a matter of cultural convention, but rather a natural, endorphin-releasing capacity stemming from our neuro-biological evolution."[43]

It is not too much to say that by this time the poet in Turner has taken hold of his science, since his conclusions are fashioned more out of glorious flights of fancy and a desire that they be true than out of solid proofs, which would require extensive investigation that he doesn't supply. The merger of science into poetry becomes increasingly evident as he extends his thinking, arriving at a metaphysic or even theology that Robin Fox refers to as his "new cosmology for the arts." Fox describes this well when he says that Turner "does not aim to abolish myth and replace it with science, but rather to use science to produce a better myth."[44] There is provocative futuristic poetry in Turner's statement that "we can imagine various phases of the process by which the human race – and other intelligent species, in cooperation – increasingly innervate the physical universe, so that it becomes that body whose nervous system is made up of individual persons... Imagine you were wired into the basic structure of Oregon, for instance; as Oregon begins to respond to your purposes, you simultaneously become transformed into something with a hot volcanic spine...Huge constellations of consciousness, animated by some immensely numinous personality and poetic theme... might emerge."[45] In his keynote address, "he posited," Limaye says, "the intriguing cosmological idea that human beings are neurons in the fetus of God."[46]

Whether all of this helps the *AAQ* and the "new renaissance" is open to debate, since it is essentially the introduction of a spectacular pseudo-scientific Shamanism, but at the very least it interjects a highly intellectualized excitement. My own assessment is that it is best to marvel at Turner's pyrotechnics, and to draw selectively from his many insights as one can from Nietzsche, but to smile skeptically, though appreciatingly, at his cosmology. But then, I am very much a Nominalist, controlled much more by an epistemological imperative to base beliefs on evidence than to seek only-partially-rooted ontological constructions. In

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[43] In the Spring/Summer 1998 issue, p. 13.
[44] In the Summer 1995 issue, p. 12.
[45] In the Winter 1995 issue, p. 34.
[46] In the Spring/Summer 1998 issue, p. 13.

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any event, I will continue to read Turner with enjoyment and fascination.

But a valuable opportunity would be missed if we concluded this article without allowing the *American Arts Quarterly*'s dialogue to provoke an examination of several important aesthetic and cultural points. I will break them into two parts: first, those relating to the sociological and ideological context; and second, those relating to the theory of art itself.

The Sociological and Ideological Context

The "new renaissance" as answering a vitally important question.

Throughout history, with few exceptions such as occured at the time of the historic Renaissance movement in Europe, commercial civilizations have suffered from a terrible flaw: the inability to generate an intellectual subculture appropriate to itself; *i.e.*, one that is fundamentally supportive and yet critical of abuses and uplifting in its desire to transcend mundane everyday life. The "bourgeoisie" has characteristically been looked upon as an assemblage of Babbitts, as in the Sinclair Lewis novel. The fault for seeing it so has resided only in part in the peculiar snobbishness of the intellectual elites; the active man (and now women, as well) of business have leant themselves to the caricature, as when John Stuart Mill found that businessmen of the 1830s could "think only of shop."

During the second half of the twentieth century, those of us who have sensed the palpitating dangers to American institutions have often asked, "why can't the mainstream society generate and support an intellectual, artistic, literary, cultural subculture appropriate to itself?"

This is why the *American Arts Quarterly* and other manifestations of a "new renaissance" are so significant. Such a renascence is, potentially, a movement of earthshaking uniqueness and importance. It is not too much to say that if it can supplant today's establishment, without becoming a stifling orthodoxy of its own, it will fill a fateful void at the heart of civilization.

That modernism and postmodernism illustrate, once again, the stultifying effects of settling upon intellectual "gatekeepers."

People in the twentieth century seem to be potently aware of how closed virtually all of the earlier intellectual orthodoxies have been; and in societies where personal freedom and democratic participation rule it is common to acknowledge the folly of Socrates' having been forced to

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drink the hemlock, of Andreas Vesalius' having been burned at the stake, even of Stalin's insistence on Lysenkoist biology. Nazi "bookburning" is recalled with horror.

There is, however, an almost complete failure to see that intellectual smugness continues to impose a "closed shop" in many important areas, and that this is accepted implicitly in the United States today. In American university communities within the social sciences and humanities, outside of Economics, all thought that is not "of the Left" tends simply to be ignored as though it doesn't exist; and certainly it is not honored and rewarded. It is a separate but related point to observe that since the late nineteenth century the American academic community has been divided into a great many specialized disciplines. The disciplines, organized intellectually primarily through their "refereed journals," are assigned virtually exclusive gatekeeper functions, since "publishing in refereed journals" is in most universities made the preeminent criterion for tenure, salary, promotion and preferments of all sorts. In many ways, given the specializations, this is imperative for convenience, assigning to the distant referees the judgmental function and thereby taking it off of faculty colleagues who often know little or nothing about a given faculty member's area of expertise. In 32 years in the academy, I have never heard anyone voice concern about this. There is no sense that the refereed journals may ever be anything other than solidly professional. The lessons of history have not penetrated this mindset. It would be impossible, the implicit premise says, for Lysenkoism to take hold of a scientific discipline, or for any ideas of value to be excluded within any other area.

And yet, here we have had for eighty years, within the arts and humanities, the suffocating orthodoxy of the modernist and postmodernist schools. The pages of the *American Arts Quarterly* tell us of on-going blacklisting and exclusion. Turner says the censorship comes from "editors, arts administrators, gallery heads, and artists themselves."[47] In a letter to the *AAQ*, Steven W. Semes writes that "the 'classical' music establishment (Lincoln Center, for example, or BAM) will not program new tonal music by living composers; museums and galleries (such as the Whitney, as its director declared...) refuse to exhibit new figurative and

[47] In the Summer 1995 issue, p. 26.

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classical art; mainstream literary magazines turn down poetry with rhyme and meter; and representatives of the professional architectural press have publicly declared that they will not publish new classical architecture, regardless of its merits."[48]

The Borders bookstore chain sponsors an annual "Banned Books" observance, during which panelists point with alarm at instances, say, in which parents object to sexually explicit material being included in middle school library collections. We continue to hear, too, about what a shameful thing the "Hollywood Blacklist" was in the late 1940s. So the concept of intellectual openness receives much lipservice within American intellectual circles. But the truth is that anything "of the Left" has, and long has had, an open field, whereas ideas that are not of the Left are like babies smothered in their cribs. A silent double standard applies to this, just as it applies to much else in our ideologically tortured time.

That, while in many ways enriching, such as Turner sees them, "multiculturalism" and globalism, as applied as weapons of alienation against Western society, have the potential of almost certainly stopping the "new renaissance" in its tracks.

Frederick Turner is well aware that the ideology of "campus and government multiculturalists" is one that, "if their vision of the world is played out, would turn America into a Rwanda or a Bosnia."[49] But he is able to divorce this realization from his otherwise global, cosmopolitan perspective. He welcomes the assimilation of many cultures, believing it is the only thing consistent with the open-society principles of a free society. He opposes what he considers to be the "Anglo-Saxon or Euro tribalism" that he sees in Samuel P. Huntington's thinking.[50]

In this, Turner seems to be seriously in error. He ought not to divorce the two things. If vast Third World immigration into Europe, the United States, Canada and Australia continues, and is combined with the main intellectual subculture's on-going attack based on its centuries-old contempt for traditional Western culture, there is little likelihood that Euro-American civilization will carry a significant legacy into the future, other than some inevitable hollow-shell residuals. What is more, even if in some way the "new renaissance" were to supplant the existing leftist

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[48] In the Summer 1997 issue, p. 44.
[49] In the Summer 1997 issue, pp. 30-31.
[50] In the Summer 1997 issue, p. 30.

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orthodoxy, so that alienation against the West were dropped from the equation, the influx of tens or hundreds of millions of people from non-Western cultures into the erstwhile European nations makes it extremely problematical whether those millions will in fact cause a synthesis, Hegel-like, into some new higher culture, one that will retain and advance the best features of the "love for beauty" that the *American Arts Quarterly* champions. The greatest likelihood of worldwide enhancement of culture will come, instead, from a Western civilization that maintains its integrity, so that its example and creations can then interplay with the many other cultures, each making its own distinctive contribution to the artistic scene.

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Essays in Eugenics

SIR FRANCIS GALTON, F.R.S.

With Biographical Introduction

by

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BOOK REVIEWS

Financial Services, Globalization and Domestic Policy Change
William D. Coleman
St. Martin's Press, New York, 1996.

Financial markets are going global. Policy makers are struggling to adjust. This book, by a Canadian political scientist, exams the policy response in five countries, the U.S., Canada, the UK, France, and Germany. As one might expect from a political scientist the emphasis is on how countries reach their decision on how to respond as much as on how countries actually responded.

The emphasis is on two industries, loan making and security trading, which at the start of the period discussed, the 1960's were generally viewed as separate industries, with separate firms in each (except in Germany). In many countries, the business of making loans was divided among different types of firms, with firms called banks specializing in loans to business firms, and other firms (saving and loans, building societies) specializing in residential lending, and a variety of other intermediaries meeting the needs of the lower income populations, the rural population, or small businesses. In most countries there was a breakdown in the barriers between these separate segments, and a move towards permitting banking firms to engage in any type of financing, including selling securities. This is referred to as universal banking. Much of this movement was driven by the concern that if domestic firms did not expand and internationalize, some of the business would be lost to more flexible foreign firms.

In security markets, the pressure was to lower the prices to users of the services and make the services more efficient. While in the U.S., the pressure for this seems to have been directed towards benefiting the consumers of financial services (here especially the institutional investors), in other countries the move seems to have been driven by a fear that the business would go abroad unless the domestic markets were highly efficient and provided services at a low price.

While the focus of the book is on the process by which change occurs, it may be most interesting for the readers of this journal to point out how large the changes are that various countries have undergone. For

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instance, France started the period in the sixties with a highly fragmented system with commercial banks, merchant banks, savings banks, and financial cooperative all operating under different rules, with special institutions handling lending to agriculture, to artisans, and to local governments. Only 15% of the financial needs of the economy came through security markets. The government owned the major banks and in addition had a highly intricate system of credit controls and allocation, with 70 different interest rate regimes covering 44% of lending. A traditional career path had top graduates from the École Nationale de Administration move to the Grand Corps of the Inspection general des finances and from there to the Ministry of Finance. After a rapid rise through the ranks they were placed as senior executives in the nationalized banks. The whole system gave the government considerable power over how credit was allocated in the economy. It also permitted the control of the volume of credit by direct means, rather than through indirect means used elsewhere.

There was a monopoly on negotiating securities transactions held by stock exchange brokers (agents de change) with fixed commissions and low capitalizations. The individuals recognized as security brokers had their status changed to companies. They were permitted to expand into managing portfolios and to raise capital by selling stock to other financial firms. By the end of 1990, 80% of the firms had been purchased by banks, while insurance companies took over others. Few remained independent. France moved much more in the direction of the universal banking model in which banks participated in all aspects of the financing process, including selling securities. In 1984 a new law put under one legal framework the various types of deposit taking.

In contrast, Germany begin the period much closer to the universal bank model, where banks participated in both the credit and the securities business. A Commission considered carefully the abandonment of the German system of universal banking, but the idea was rejected. Indeed, the European Community endorse the universal banking idea when its Second Credit Directive permitted banks to engage in security dealing, portfolio management, and other investment services. The German banks position was further strengthened when the community decided to give banks access to the stock exchanges in all member countries.

Bigger changes were required in securities. Under the German

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Federal system, the Landes had regulated the security markets. They were reluctant to do anything to handicap their local exchanges, although if Germany was to compete with London and Paris for international business it needed to concentrate its business in its largest exchange, Frankfurt. Inspired by international competition, a series of measures were undertaken to promote the Frankfurt market. In 1989 a revised stock exchange law opened the way for a fully computerized exchange and for a futures and options exchange. In 1990, the Federal government passed a law which removed the stock exchange turnover tax and broadened the categories of securities allowed for inclusion in investment funds. The Bundesbank finally agreed to the issuance of money market securities, and a corporate commercial paper market begin to emerge. Five regional security deposit banks were amalgamated into one, which gave Germany the fastest settlement system in the OECD countries. To further centralize things, the ownership of the Frankfurt exchange (along with that of the central security deposit bank) was vested in a new countrywide company which was 80% held by the banking industry, 10% by the Lander, and 10% by the security firms. To give the Frankfurt exchange creditability, a new central federal regulatory body was set up to deal with such things as insider trading.

In the sixties, London had a very informal regulatory system in which the Bank of England exercised informal supervision over the small number a major banks. The system worked as well as it did because the bank leadership and the Bank of England leadership had similar backgrounds. This informal regulatory system attracted business from the rest of the world, including the U.S., who found their costs were lower. But yet this internationalization contained the seeds of its own destruction, since those attracted by less formal regulation were not particularly concerned about the norms of "gentlemanly" behavior.

At the start of this period the commercial banking industry had little interest in the mortgage markets and the financing of British housing was handled primarily by building societies, which were limited to this function and raised their funds from members. A new Building Societies Act in 1986 left the societies focused on housing but gave the Building Societies permission to raise 40% of their funds from non-retail sources, including the money market. They were also allowed to diversify their lending to a certain degree. Provision was also made for Building Societies that wanted more freedom to convert to banks, and several of

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the largest did. Meanwhile, market deregulation permitted the banks to move into the traditional territory of the building societies. They captured 30% of the market by 1989. Interestingly, there is little discussion of the British Big Bang (in which the British securities market was reorganized), but some of the changing structure of securities regulation.

In Canada, the financial services industry had traditionally been built around four "pillars," banking, trusts and estates management, insurance, and security dealing. Each was controlled by Canadian firms, even though much of other Canadian industries was American controlled. Again competitive pressures from globalization led to interest in desegmentation, and making Canadian firms large enough to be internationally competitive. The Federal nature of Canada complicated desegmentation, and the required harmonization of the regulations for different types of firms. The provinces had traditionally regulated businesses, including most financial ones, with Quebec particularly jealous of its prerogatives. However, the Canadian constitution assigned "banking, the incorporation of banks, and the issuance of paper money" to the Federal government. This led to there being a category of Federally chartered banks. Whatever they were allowed to do was defined as banking.

The core function of the trust companies, the management of trusts and estates, caused them to be originally provincially chartered. However, by receiving money "in trust", paying interest, and guaranteeing the return of the money, they became takers of time deposits. Since they could invest the money they held in trust, they were also in the business of lending money. These companies could get charters from the Federal government for these functions. Provincially regulated financial cooperatives also emerged, and engaged in deposit taking and lending. The result was a group of near banks that were banks in all but name.

In the 1980 Bank Act, the chartered banks' monopoly of the payments system was eliminated by setting up a new payments system, the Canadian Payments system. Federally chartered banks had to join, and other deposit takers could join. In practice the largest non-bank ones did. The chartered banks were allowed to become full competitors with the trust companies, and cooperatives in the residential mortgage field. In practice, trust companies came to be frequently owned by banks. By the mid-nineties, chartered banks could operate in all financial areas either directly or through subsidiaries, with financial cooperatives in Quebec and British Columbia having similar commercial freedom. Trust

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companies were freer, but still subject to some restrictions.

Canadian chartered banks had traditionally traded in fixed income securities and money market instruments, while separate security firms (provincially regulated) underwrote corporate debt and equity, and did equity trading, and investment management and counseling. Foreign firms were not allowed to own these security firms.

This division was threatened when the Bank of Nova Scotia exploited a loophole to register a securities subsidiary in Quebec. Ontario, afraid other banks would open security subsidiaries in Quebec (taking business away from their firms) announced its intention to permit banks and trust companies to own securities subsidiaries and to open up ownership of securities houses to foreigners. About this time the Federal government expressed its desire that banks be able to enter the securities business. After discussion, the banks were allowed to set up subsidiaries under provincial regulation for the provincially regulated securities businesses (while continuing their traditional trading of debt securities under Federal oversight). The result was a Canadian "Little Bang" on June 30, 1987.

Thus there was a substantial merging of the securities and banking business. All of the "Big Six" banking firms went took over a securities firm or started their own, and by 1990 over 80% of the securities business was under the control of commercial banks. Following Federal legislation, the banks moved into the trust and estates area by purchasing companies or setting up subsidiaries. By 1994, three of the four largest trust companies were bank owned.

The result of this desegmentation of the Canadian financial services industry was to increase the size of the Canadian banks, and to position them to compete better on the international scene, especially with the American banks. Canada has entered into a free trade agreement with the U.S. and Mexico which had provisions covering financial services, permitting U. S. banks to compete in Canada.

The United States started this period with the most fragmented system of any of these nations. The McFadden Act prohibited new branching across state lines, and many states prohibited banks from any branching. One Federal regulation limited thrifts to making loans within 50 miles of their branches. Commercial banks were prohibited from underwriting commercial debt and equity securities.

This system begin to unravel in the sixties. Vietnam era inflation

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raised interest rates. Commercial borrowers discovered the small commercial paper market. The commercial banks responded by introducing their own money market instruments, negotiable certificates of deposit. The higher market interest rates created problems since thrifts and banks had built their business on taking in deposits at low rates, and lending them at higher rates. Money market mutual funds were invented, and thrifts begin to lose deposits. If the thrifts responded by purchasing funds on the money markets, they could easily be paying more for the deposits than they were earning on the loans. This produced the U.S. saving and loan crisis, and a massive (150 billion dollar) Federal bailout.

Market desegmentation in the U.S. proceeded in stages. The Depository Institution Deregulation and Monetary Control Act of 1980 loosened interest rate ceilings, increased the flexibility of savings and loans to make mortgage loans, and permitted thrifts to hold commercial paper and to expand into services like personal loans, credit cards, etc. The Federal Reserve Board was also given power to set reserve requirements for all transactions accounts of depository institutions.

The last of a series of deregulatory Acts in 1994 permitted bank holding companies to expand into any state. However, by then most states had already permitted branching through their own laws.

The above is just a sketch of the changes in financial services that occurred in different countries. This review has focused on the actual changes, but since this is a book by a political scientist, much of the discussion concerns the mechanism by which these changes took place. Particular emphasis is placed on the nature of the policy communities, i.e. who the players were and which organizations (commercial and governmental) and types of firms were involved in the discussions. The most important finding is that consumer interests appear to be under represented in a process that is dominated by the financial institutions themselves and a few governmental bodies.

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Markets and People: The Czech Reform Experience in a Comparative Perspective
Jiri Vecernik
Avebury, Aldershot 1996

Institutional Design in Post-Communist Societies: Rebuilding the Ship at Sea
Jon Elster, Claus Offe, Ulrich K. Preuss, Frank Boenker, Ulrike Goetting & Friedbert W. Rueb
Cambridge University Press, Cambridge 1998

The collapse of the Soviet Empire ruined the careers of quite a number of academics. Some Sovietologists managed to adapt their skills and become experts on Russian affairs. But Kremlinologists, academic experts on deducing the Soviet power hierarchy from the position of leaders on Lenin's tomb during May Day celebrations, disappeared. Still, new academic specializations emerged after 1989. Chief among them is "Transition Studies," the study of the transformation of postcommunist countries from political totalitarianism and command economy to free market democracy. Many transitologists are economists.

Former Czech Prime Minister Vaclav Klaus used to compare the reformers and entrepreneurs in the postcommunist world to the first white settlers of America. "The settlers came first and the law second." But when the first white men came to America they faced an embarrassing surprise: though they assumed that they were going to the eastern part of India, they discovered they were actually in an unknown new continent. When economists came to transform the command economies of postcommunist countries they also had to face an embarrassing surprise: the assumptions of classical economics fail in the postcommunist context because economic transitions take place within structured societies.

People do not behave in the real world as abstract economic agents of economic theory who attempt just to maximize their profit in a market. Economic behavior is affected by the social contexts in which economic agents are embedded, by their affiliations with a social network, for example, their membership in the old nomenklature. The existence, integrity and independence of institutions such as the police and the judiciary determine whether the rule of law and property rights that are the foundations of any liberal economic system will be enforced. For example, if there are no regulations to prevent embezzlement and theft by

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company managers; or if the existing regulations are not enforced against criminals with political networks, the assumption of classical economics that wealth is created only by enterprise, labor and free exchange becomes irrelevant. Finally, traditions and habits keep influencing economic behavior irrespective of political changes. For example, the behaviors of the monopolies that dominate the Czech economy and the government bureaucracies that are supposed to control them continue their pre-1989 habits and norms.

The rules of economics are not like the laws of physics: they do not hold everywhere, but only when some social-institutional conditions are satisfied. As anybody who read Hayek knows, a free market without the rule of law, without the institution of private property and an active honest police and judiciary is impossible. A postcommunist economy where these social conditions are not reformed becomes a Valhalla of the *nomenklatura*.

The recent books by the transition expert Jiri Vecernik and the American-German research team headed by Elster, Offe and Preuss examine the neglected social aspects of postcommunist transitions. Vecernik, probably the best Czech social scientist, applies sociological criticisms of the assumptions of classical economics to offer a better social understanding of the Czech economic transition. Elster et al. compare the institutional changes after the fall of communism in Bulgaria, the Czech Republic, Hungary and Slovakia.

Vecernik examines the process of transition in the Czech Republic from the perspective of the Czech household: how did the changes since 1990 affect Czech families, their incomes, employment, survival strategies, poverty, welfare, and political approaches, in comparison with other postcommunist countries. Vecernik examines an impressive and massive array of statistical and survey data to draw from his sociological conclusions. The strength of the book is in combining economic with sociological data to understand the peculiarities of the Czech transition.

For example, Vecernik uses sociological theory to explain why the Czech "privatization" process resulted in a continuity in real ownership from the Communist period. Before 1989 the state was the nominal owner and the managerial *nomenklatura* exercised actual property rights. Czech "privatization" privileged the nomenklature whose strong social networks insured they had the capital, inside information, and *de facto* government subsidies to go on controlling the businesses. Only the social

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structure of Czech society, the unity of the nomenklature and the passivity of society can explain the economic fact that at the end of the process of pseudo- privatization the state still is the nominal owner through the national property fund that owns the banks that own the investment funds that own the "privatized" firms. The incompetent *nomenklatura* management continues its pre-1989 traditions by exercising actual property rights that lead to "tunneling," of company assets out of the country and consequently to loss making. Then the bank managers continue in their communist habit of subsidizing firms through of bank loans. Large privatization was a case of transition from "real socialism" to socialism without adjectives.

In the last chapter, Vecernik attempts to connect his conclusions about the socio-economic situation with political developments. He sees a trend of consolidation of party loyalty according to class interests. The last elections vindicated his thesis. Workers tended to vote for Czech Social Democratic Party (CSSD) and entrepreneurs tended to vote for the former ruling Civic Democratic Party of ODS of former prime-minister Klaus. Still, Vecernik missed noticing what is missing: civic society. In older democracies, interest groups, lobbies and professional associations mediate and connect the population with the political parties. This does not exist here. Therefore the parties find it very easy to disregard the interests of their electorate and act in their own interest as was exemplified again after the last elections when the leaders of the "right" and "left" agreed to form a coalition to eliminate the Czech political center and weaken the power of president Havel by changing the constitution.

Elster et al. examined comparatively the transition of institutions in postcommunist societies. They measured the transitions by the separation of economic, legal and other institutions from the political and by the establishment of clear, recognized and enforced constitutional rules. When the authors finished their book in 1996, the Czech Republic seemed to them to be doing better than Hungary, Slovakia and Bulgaria. Though they well understood the situation in other postcommunist countries, they failed properly to understand the nature of Czech pseudo-privatization. In fact, the Czech transition is quite similar to the Slovak transition. In both countries the economic and political elites are closely intermeshed and the judiciary and the police are too corrupt or timid to enforce the rule of law on the politico- economic elite. The difference is in style and public relations. In Slovakia the politicians gave

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state firms to their cronies, interfered crudely in the operation of the police and the judiciary, and changed the constitution to serve political goals. Czech politicians did the same but sought to hide it.

Unfortunately, public relations cannot maintain economic growth. The lack of restructuring of the Czech economy and institutions led to low productivity and loss of competitiveness that generated the current course of slow economic decline. Reversing the economic decline will require restructuring Czech institutions such as the police, the judiciary, the state bureaucracies, and the education systems. It will require separating the economic and judicial institutions from the state, and the consolidation of a constitution that will protect property rights.

The first post-1989 Czech political elite comprised dissidents, intellectuals and philosophers. The second elite was of economists. Both shared a cynical approach to institutions. The dissidents valued personal decency and "life in truth" and perceived all institutions as inherently corrupt. The economists regarded institutions as natural obstacles to the success of entrepreneurs and politicians. Both were proven wrong. Without decent institutions, individual decency is under serious threat; without enforcement of the rules of the free market competition and property rights there are no incentives for economic growth.

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Columbia University

Revolution from the Middle
Samuel Francis
Middle American Press, 1997

This book is a selection of articles by columnist Samuel Francis that appeared between 1989 and 1996. The result is that instead of understanding his thought in fragments, we are able to grasp it as a whole. Even those who have read his work over the years will benefit from this volume.

Francis's is one of the more uncompromising voices of American cultural conservatism. As such, he is widely read by those express concern at what they perceive as a rapid erosion of the social, demographic and political foundations of the traditional American way of life, but who see little comprehension of or desire to repel that erosion within either the elite or the population in general. At the same time, the "radicalism" he calls for is not that of the "right-wing militias," since "as

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long as legal and democratic procedures for political and social change remain available, there is no reason" to resort to other means. This is an important qualification, since violence on behalf of cultural conservatism would almost certainly result in monstrous consequences far removed from what conservatives such as Francis desire. As forlorn as the chances may be, there is no alternative for American conservatives but to struggle to gain peoples' loyalties through a competition of ideas.

Francis' doctorate from the University of North Carolina in Chapel Hill was in modern history, and it is socio-demographic analysis that Francis brings to bear rather than primarily an explanation of economic or political theory.

He breaks American history into three phases: the First Republic that existed before the Civil War; the Second Republic that prevailed between the Civil War and the New Deal; and the current phase. Throughout most of the twentieth century, the core issue in American life has been whether to preserve to any significant degree the classical republicanism that typified the First Republic. The slide away from that republicanism has been a long one: the bourgeois elite that predominated after the Civil War lost its economic independence, and with it its place as the defining core of American society, when large-scale organizations began to "swallow the independent businesses and farms." The middle class since World War II has amounted, in fact, to an "affluent proletariat" highly dependent upon the national government. "Alienated from the nation's past by its size and rootlessness, it retains only a fragmented memory of and identity with the historic national experience."

The leading role in American society, according to Francis, has been assumed by a "managerial elite," which in the context of today's global market is now becoming a transnational elite. Its members, we are told, constitute "the real rulers, invisible and immoveable, [who] never even flutter their eyelids when the body politic twitches in the quadrennial presidential election." Many of the voters this elite requires for political success come from its alliance with "an unassimilated underclass." It is this alliance that governs a confused, uncommitted and largely oblivious mainstream of Americans whose primary value – in their self-absorption, shallowness and materialism – has become having fun. These observations are particularly important because they help answer the crucial question, which is why the great bulk of ordinary Americans are so inert and acquiescent.

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This elite sweeps all before it in its "politically correct" consensus that includes several elements: the aspiration for a "New World Order" that will provide a global version of the welfare-state therapeutics that has long-since become the basis for American domestic policy; an internationalism that seeks an homogenization of the world population and the ultimate extinction of the nation-state, most especially including any distinct identity for the United States and its people; free-trade ideology; a preoccupation with economics at the expense of other values; and, though the elite operates through the democratic institutions that Americans have inherited from the past, the allowance of no genuine dissent.

In the face of this, the American "conservative movement" no longer exists in any meaningful sense. Jerry Woodruff, editor of the *Middle American News*, says in his Preface that it has been supplanted by an "obsequious Right with its embarrassing corporate sycophancy." "The management of [both] parties," Woodruff writes, "remains safe in the hands of those who share a common globalist outlook in pursuit of free trade, open immigration, and the dismantling of the West's distinct cultural identity." Francis seconds this when he points out that "the differences between the parties are far outweighed by their similarities." Many "conservatives" embrace "policy-wonk" economic and political reforms that ignore the cultural conflict.

And yet Conservative columnist Francis isn't without hope. He sees the potential for what he calls a "middle American revolution" that can arise from among those who bear the brunt of the elite-underclass alliance. He sees this as a populist movement made up of such elements as lower middle class white ethnics, the Reagan Democrats, and "the Bubba vote" – in broad terms, all those who understand today's government as "favoring both the rich and the poor simultaneously." Francis adopts sociologist Donald I. Warren's category a few years ago of "Middle American Radicals." Their issues will be much broader than simply those of the "religious Right." An interesting aspect is that they are culturally conservative while they at the same time support "economically liberal policies such as Medicare, Social Security, unemployment benefits, and economic nationalism and protectionism."

With all of this and more, the book is a clarion call to those who see American culture as under attack and want to preserve its main features. Here are some observations that can be made by way of

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addition and critique:

1. Francis's historical, sociological understanding of American history would be greatly enriched if he were more distinctly conscious of the existence within Europe and the United States since the early nineteenth century of a phenomenon commonly called "the alienation of the intellectual." Virtually since it emerged from the *Ancien Régime*, bourgeois society has been "without a head," except for such intellectual leadership as a grossly outnumbered cadre of classical liberal thinkers has been able to give it. The artistic and literary culture has for almost two centuries excoriated the main society, and has sought successive alliances with a variety of unassimilated or disaffected elements. There has been no more fateful fact about modern civilization. The American "managerial elite" that Francis sees as central has imbibed most of its *ethos* from that intellectual culture, which in turn has become a leading segment of the U.S. elite.

A full comprehension of that intellectual history wouldn't contradict Francis's exposition, but it would add considerably to it. It would show that the plight of the commercial middle class – the "bourgeoisie" – is of long standing, going back even so far as to the Greeks and the Romans. Other than certain exceptions during the Renaissance, the "bourgeoisie" has at virtually no time or place enjoyed or engendered the support of an intellectual class. Such support, when present, would ideally understand a commercial civilization's merits and simultaneously seek to elevate its spiritual and ideational life. When Francis says the Middle American Revolution will need to "construct its own head," he seems not fully aware that he is calling for something unique in history.

2. This observation merges into the next one. Francis's analysis points to no underlying dynamic that offers any hope that a Middle American resurgence will actually occur. He implores it to happen, and as with most thinkers yearns to have his ideas taken seriously by enough people to spur them to action. Although this reviewer isn't accustomed to citing Karl Marx as an authority, it is worth recalling Marx's criticism of all socialist theories other than his own on the ground that they had no theory of history that would explain just how it was that society would come to embrace their views.

If it were simply a matter of imploring Americans to "wake up and see the crisis confronting them," there would be little ground for hope by cultural conservatives. The average middle class American seems to lack

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an informed interest in broader issues and is currently too prosperous and too absorbed in his daily preoccupations for that.

There is, however, much prospect that that self-satisfied world is going to be turned upon its head by the ravages of down-sizing brought on by low-cost global competition and even more by near-workerless technology. As life becomes dramatically riskier and scarier, perhaps people may begin to think. Therein lies the opening for any thoughtful paradigm that can address the problems constructively. Francis's ideas certainly speak to the needs. An important next step will be to fit them into the coming crisis of the wage system, so that people will see more immediately what their relevancy will be.

3. A part of this must necessarily be to spell out in some detail an attractive economic, social, cultural and political paradigm for the coming age. Francis gives this little attention himself, appearing to presuppose a body of theory that is in writing elsewhere. But it requires a lot of work and of working-out, since American institutions and policies of "classical republicanism" from the "First Republic" – however desirable cultural conservatives see them to be – just won't suffice, at least not as taken right out of the package.

Right now, writings such as those by Francis seem to be "on the fringe" of the contemporary scene. But this is an illusion. They will be vastly important in the enormous ferment of ideas that is bound to occur during the next few years. They will be important to people of all ideological persuasions who seek seriously to weigh the alternatives or even to know what others are thinking.

Dwight D. Murphey

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University of Florence, Italy

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